April, 2017

PENNIALL PERSPECTIVE

"It's not uncommon for valuations to depart from fundamentals and we're in a situation like that now. History shows it always gets back to the fundamentals."

- Steve Scruggs, Portfolio Manager of Queens Road Funds

Economic Watch

Economic data was mixed for 1st quarter 2017. On the positive side, unemployment fell to 4.5%, a level not seen since before the Financial Crisis. New orders for US durable goods went up 1.7% month-over-month in February driven primarily by a 47% surge in civilian aircraft orders. This followed an upwardly revised 2.3% jump to start the year. In addition, so-called "soft-data" components such as consumer confidence, business optimism and other sentiment indicators continued their post-election strength, helping fuel the belief that the economy has finally reached liftoff speed. This evidence also prompted the Federal Reserve to initiate its second rate hike in four months, with Fed chair Yellen stating "*The simple message is the economy is doing well. We have confidence in the robustness of the economy and its resilience to shocks.*"

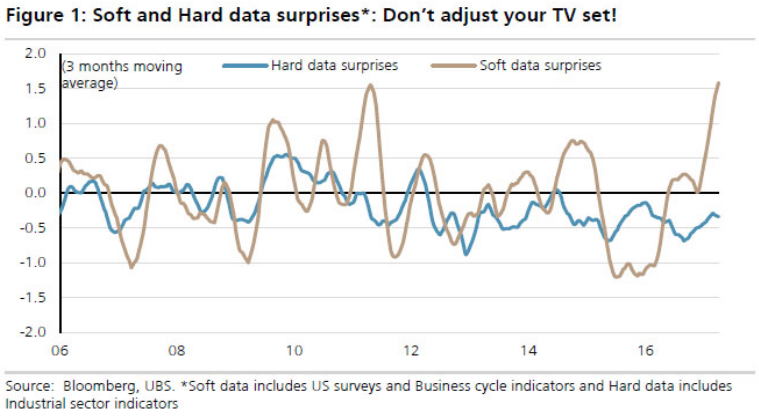
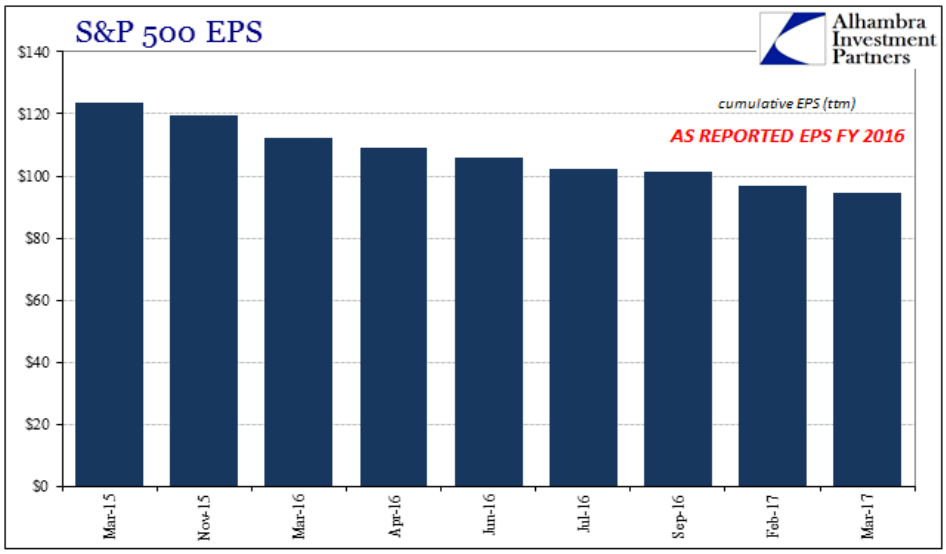


Figure 1: Soft and Hard data surprises*: Don't adjust your TV set!

Source: Bloomberg, UBS. *Soft data includes US surveys and Business cycle indicators and Hard data includes Industrial sector indicators

Despite Fed confidence, actual "hard data" such as GDP growth, auto sales, commercial & industrial loans and retail sales have continued to weaken (Chart 1). In fact, retail sales posted negative back-to-back monthly growth rates in March, its lowest reading in two years. After-tax corporate profits are stubbornly stuck at 2011 levels. As Chart 2 shows, earnings are down almost 20% from 2 years ago, albeit Q1 expectations indicate slight improvement. Recent Atlanta Fed estimates for Real GDP growth fell from over 3% in the beginning of January to a meager 0.5% at time of writing. Moreover, nominal GDP rose just 3.0% during 2016, the weakest annual growth rate since 2009 (note: nominal GDP is not adjusted for inflation and unlike the previously and more commonly quoted real GDP). As Lacy Hunt of Hoisington Investment Management states



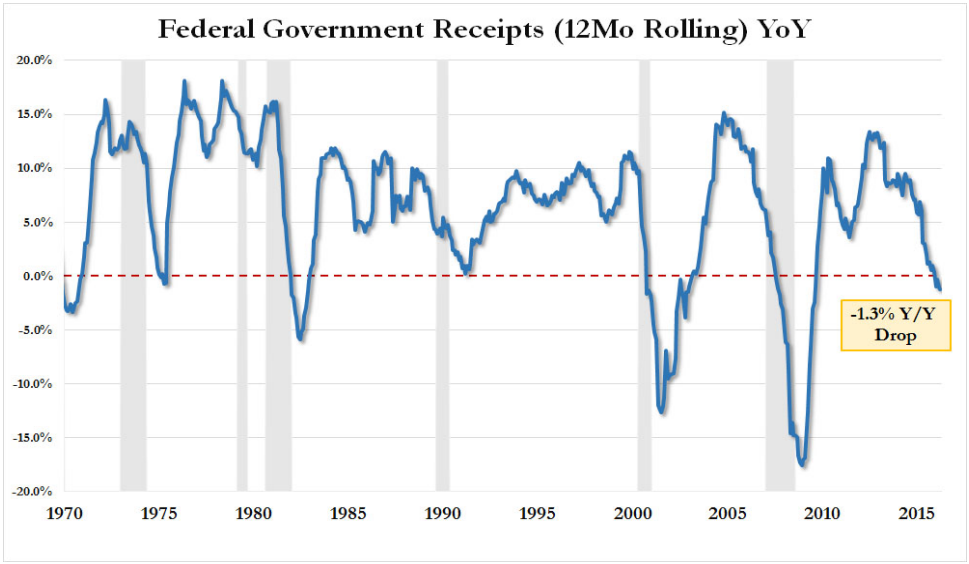
in their 1st Quarter, 2017 Review and Outlook "*the Fed did not change its 2017 economic growth projections even though the broader first quarter indicators were even softer than last year, and their prior forecasts were made before they hiked the funds rate in December. Indeed, all of the key monetary variables that are heavily influenced by Fed policy operations deteriorated in the first quarter*."

Overseas, European and Asian economies improved with both regions realizing an increase in GDP. While it is too early to tell the magnitude of the 1st quarter uptick, early estimates project UK growth to be above 1.5% and overall Eurozone growth to be even higher. In Asia, both China and India expected growth rates continue to exceed 6%. Japan saw February exports expand at a double-digit clip for the first time in over 2 years and higher demand for Japanese goods boosted activity in the manufacturing sector.

Outlook:

In our view, this year's optimism in economic forecasts were driven by anticipated fiscal policies resulting from a same party President and Congress. Though it is quite likely that a healthcare and tax reform bill will pass this year, sentiment is getting tempered by political realities. Any achievable reforms may provide a "soft data" reprieve, but will take a number of years before truly flowing into the system and stimulating economic growth. It is also crucial to note that the last 10 Fed tightening cycles preceded financial crises and that the current cycle is taking place with weaker economic growth than ever before. With history as our guide, we believe this will put additional downward pressure on the economy as higher borrowing costs suppress future growth.

In addition to the debt and growth concerns, two critical fundamental economic indicators have continued their softening trend: M2 money supply growth and monetary velocity (the rate at which money is exchanged from one transaction to another and how much a unit of currency is used in a given period of time). Until we see these two important factors begin to accelerate, it is unlikely that "hard" data will experience the liftoff we all hope for. Another anecdotal data point involves tax revenues. With supposed strength in the economy and employment, we would expect Federal Government tax receipts to be increasing. Instead, Chart 3 shows tax receipts have actually been on the decline. At this point in time, eight years into a recovery and with many indicators weakening rather than strengthening, our analysis is consistent with those who believe 2017 nominal GDP will be even lower than last year's anemic pace.



In our view, the recent uptick in the global economic data, while encouraging, is unsustainable. The debt levels in both Japan and China have reached peaks that are problematic for long-term growth until resolved. We also believe that the populist fervor and political issues in Europe, especially in regards to the upcoming French and Italian elections that put the fate of the Euro into question, will continue to strain their economies.

Market Watch

The US stock market continued its multi-year advance led by technology and healthcare stocks. International equities posted even stronger returns than domestic, especially across Asia and throughout the emerging markets. Equity precious metals also realized solid gains during the quarter. Intermediate and longer-term bond yields declined slightly, which translated to positive bond returns while short-term interest rates rose.

Below is a summary of yields and returns for Q1 2017:

- Barclays U.S. Aggregate Bond Index Q1 return: 0.82%
- 10-year U.S. Treasury yield ended Q1 at 2.40%, virtually unchanged from 2.45% at the beginning of Q1
- 30-year U.S. Treasury yield ended Q1 at 3.02%, virtually unchanged from 3.04% at the beginning of Q1
- S&P 500 Q1 return: 6.07%
- Dow Jones Industrial Average Q1 return: 5.19%
- MSCI EAFE Q1 return: 7.25%

Outlook:

It is difficult to justify all-time highs in equity markets when underlying fundamental data has experienced disproportionately less growth. Valuations under many metrics are at or near all-time highs including Price/Sales, Price/Book, Price/Market Capitalization, Price/CAPE earnings. Margin debt levels are at all-time highs, creating massive downside risk should the markets weaken. Our belief is that equity prices have been artifically buoyed by Federal Reserve policy and, more recently, expectations for business-friendly policy changes. As the Fed continues its tightening cycle and reality for policy implementation sets in, we believe the market may no longer have enough artifcial support to maintain current prices.

Our stance remains that interest rates are likely to continue to trend lower as global debt weighs on GDP growth. Global rates are once again trending lower with the German 10-Year Bund at 0.2% and Japan's 10-Year Treasury now close to negative territory. The US 10-Year Treasury is likely to retest its July 2016 low and high yield spreads are likely to widen, in our opinion.

Portfolio Allocations

Our macroeconomic viewpoints continue to point us towards conservative equity exposure until we find more attractive valuations to move into more aggressive allocations. On the bond side, we prefer mostly high quality, longer-duration bonds as we maintain the belief that the low in interest rates is yet to come. Most portfolios were rebalanced back to target allocations during Q1 as part of our normal account maintenance.

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