January, 2017

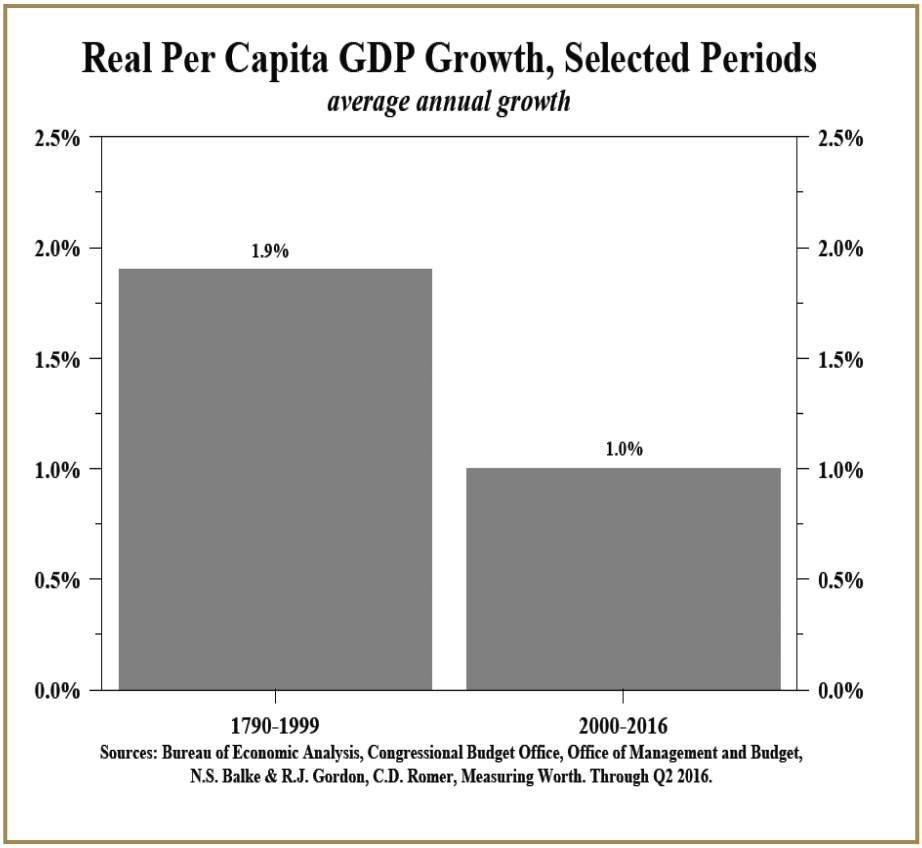
PENNIALL PERSPECTIVE

"It is better to be three hours too early than a minute too late."

- Falstaff, in Shakespeare's The Merry Widows of Windsor

Economic Watch

This past year, 2016, was definitely one for the ages. Any poll taken that indicated a favorite, and any party or candidate that expected to win, all seemed to end with a loss or surprise. From the UK voting to exit the Eurozone (BREXIT), to the surprising nomination and ultimate victory of Donald Trump, to the rejection by Italian voters of their referendum to strengthen ties with Brussels (and the European Union), all ended in surprise winners and losers. Yet through it all, the equity markets seemed to revel in the unexpected, with global markets recovering quickly following a sharp post-BREXIT decline, followed by virtually an overnight reversal from market weakness to market strength with the Trump election. The world's economies all seemed to chug along, albeit at a much slower pace than desired or forecasted. US GDP likely grew at an inflation-adjusted (real) rate of slightly more than 2% annually in 2016. This past quarter, while not as robust as Q3, probably grew around 2.8% when final figures post in March. In addition, PMI (Purchasing Managers Index) and ISM (Institute for Supply Management) surveys both ended the year on stronger data, which portrays an improvement in the manufacturing sector. Retail sales also grew about 4% in 2016 according to the Census Bureau forecast, though many retailers with "brick and mortar" stores have not fared well as compared to online retailers.



It should be noted, however, that real GDP growth has failed to exceed 3% for the 11th year in a row, a record including even the depression years. In fact, as the chart to the right depicts, since 2000 real per capita GDP is about one-half the growth rate of the prior 210 years of our country's history.

Here are the summary growth rates of GDP for all four quarters in 2016:

(Q1): 0.8%
(Q2): 1.4%
(Q3): 3.5%
Composite (Q4) forecast: 2.8%

Globally, economic data has shown gradual improvement, although from much lower levels than the US. Eurozone GDP continues to grow at a very modest pace of 0.3% through the end of Q3, and most recent trailing quarter data shows a

modest pickup in inflation and industrial production. Year over year data shows an approximate 1.7% increase in GDP with 2016 expected to maintain that same pace. Japan, struggling with an aging population and significant debt issues, continues to fight deflationary forces but does remain positive, with GDP at a rate of 0.3% in Q3 and a similar rate expected for Q4. China continues to see gradual declines in their GDP growth rate as increasing debt becomes a greater burden on their economy.

Outlook:

Despite the recent pickup in GDP for the last two quarters of 2016, it is our view the ongoing decline in the GDP growth rate will likely continue its downward trend. We believe the main culprit for this anemic growth is one word – DEBT. Not only does Federal debt now total about $20 trillion (over 105% of GDP), but also household and corporate debt are at historic highs. Total US public and private debt is now estimated at over $65 trillion, or about 350% of GDP. Unfortunately, many academic studies show that when debt reaches these levels there is a profound negative impact on future economic growth. While the newly inaugurated Trump administration has set lofty goals of achieving 4% GDP growth in the coming years, our view is that this goal is likely unattainable without a substantial change in debt accumulation.

Market Watch

The US equity markets finished the year strong with the S&P 500 over 3.8% for Q4 and about 12% for the year. Some other indexes were even stronger, with the Dow gaining 8.6% and 16.5% during the same time periods and two sectors, energy and financials, both gaining in excess of 20% each. International markets were generally weaker with MSCI EAFE index losing -0.71% for Q4 and gaining only about 1% for the year. Gold ended up about 8% but the real achiever for 2016 was the gold mining stock index (GDX) which gained over 50% despite wild swings during the year.

Interest rates dropped during the first half of the year, with the 10 yr. Treasury hitting a 200 yr. low of 1.37%, but then gradually increasing and ending the year higher. Overseas interest rates followed a similar pattern, albeit with yields substantially lower than ours in the US. In fact, the German 10 yr. Bund is currently yielding 2% less than our 10 yr. Treasury.

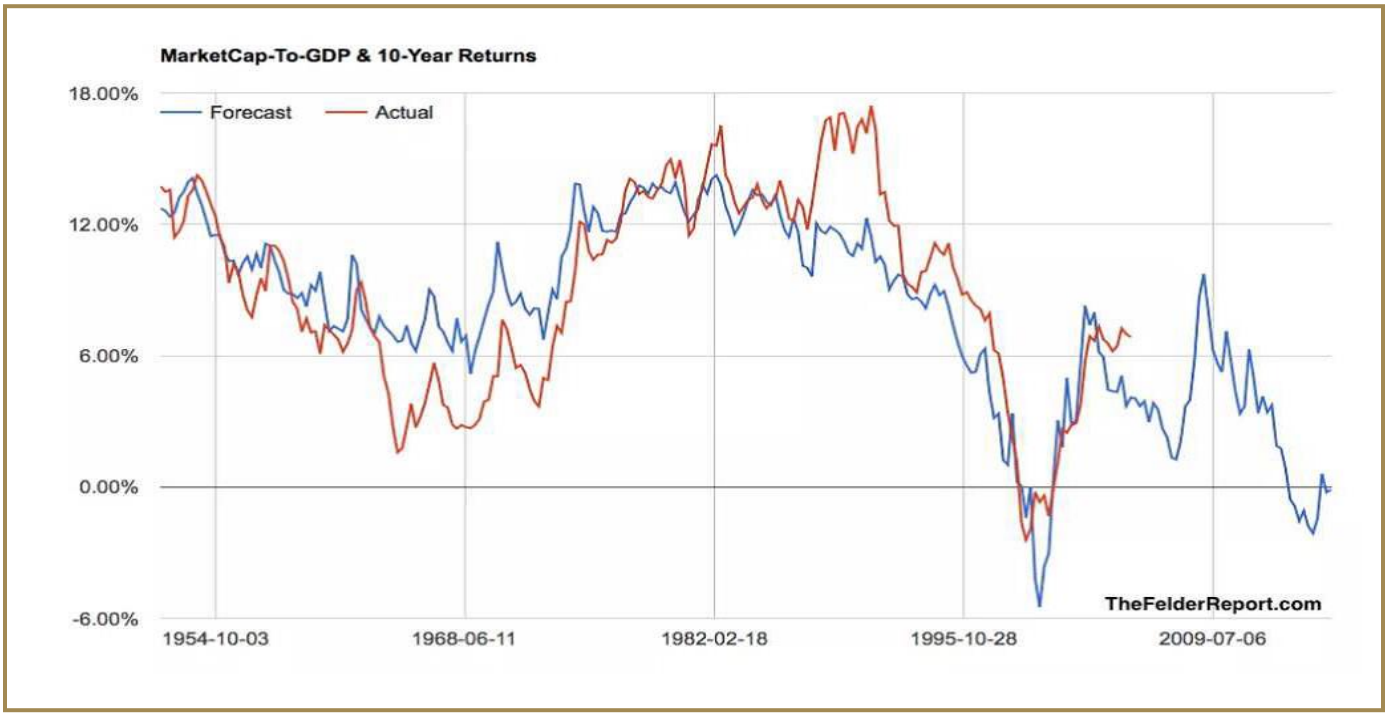
Below is a summary of yields and returns for the quarter and year:

- Barclays U.S. Aggregate Bond Index Q4 / 2016 return: Q4: -2.98%; 2016: 2.65%
- 10-year U.S. Treasury yield ended Q4 at 2.45%, up from 1.60% at the beginning of Q4
- 30-year U.S. Treasury yield ended Q4 at 3.06%, up from 2.32% at the beginning of Q4
- S&P 500 Q4 / 2016 return: Q4: 3.82%; 2016: 11.96%
- Dow Jones Industrial Average Q4 / 2016 return: Q4: 8.66%; 2016: 16.50%
- MSCI EAFE Q4 / 2016 return: Q4: -0.71 / 2016: 1%

Outlook:

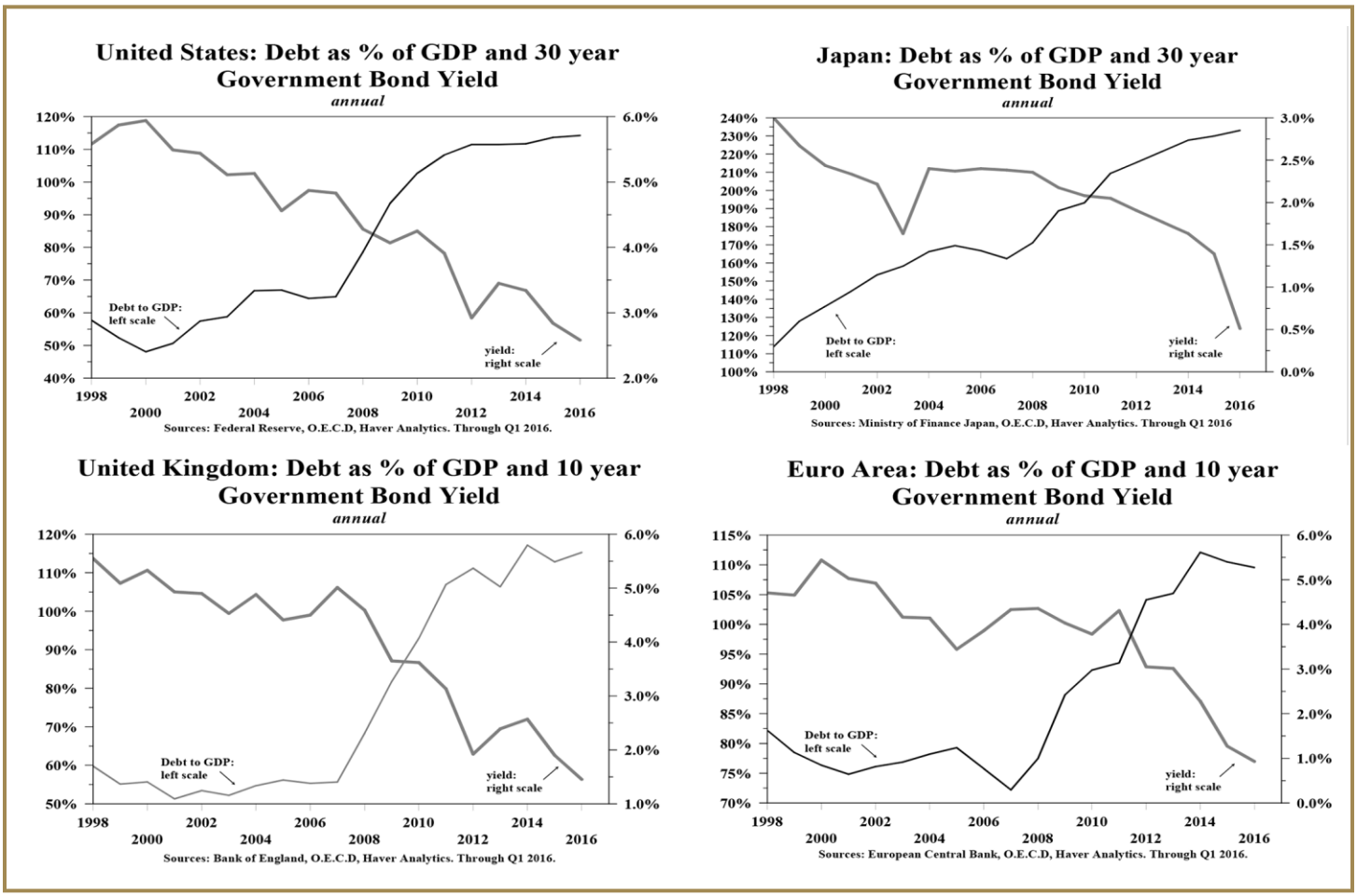
The positive stock market sentiment that developed almost immediately following the election led to substantial gains for the balance of 2016. Most analysts attribute this euphoria to a much more business-friendly administration, and proposed tax cuts and deregulation that could possibly benefit the bottom line of many corporations. In addition, there is a strong argument that if repatriation of corporate profits sitting overseas in US company affiliates are brought back to the US, it would provide an additional boost to corporate profits. All told, the combination of the aforementioned policies and the recent uptick in inflation would lead us to a period of higher economic growth, higher interest rates and inflation.

Unfortunately, it is too early to tell if the above will lead to the intended outcomes. Consequently, our outlook has remained the same for the time being as we watch for what change will actually take place. Regarding the stock market, the data continues to show extreme overvaluations and stagnant top-line and bottom-line income for publicly traded companies. In fact, virtually all the fundamental indicators we follow are at or near all-time overvalued levels. While these are not good short-term indicators of market direction, they do give us a fairly accurate expectation for the potential longer-term returns in stocks. For example, the below chart is a forward-looking forecast on the S&P 500 returns based on the stock market capitalization compared to the economy (aka GDP). This calculation, also known as the Buffet ratio (made popular by Warren Buffet), has been useful over time to determine if stocks are overvalued or undervalued. As you can see, the blue line (forecast) has been highly correlated to actual future returns (red line). Given where the blue line is today, the expected future rate of return for the next 10 years on the S&P 500 is about ZERO. Other fundamental indicators we use confirm these extremely low returns as well. Hence, our outlook is that US stocks will likely correct unless these and other fundamental financial metrics improve.



Regarding long-term interest rates, our outlook has also remained the same. We continue to believe that Treasury and high-grade corporate bonds are the centerpiece to positive returns in portfolios given today's market conditions, despite the Fed's intention to raise short-term rates. The increased debt, coupled with declining monetary velocity and slowing nominal GDP growth, leads us to believe that long-term interest rates will likely continue their 35 yr. trend lower. According to David Rosenberg of Gluskin Sheff, currently only 6% of global asset managers expect interest rates to fall, and 58% of managers are underweight bonds. The expectations of higher rates and lower bond prices is extremely high and it's our belief that disappointment will come again, similar to the outlook at the beginning of 2014 when 30 out of 30 Wall Street Journal economists predicted higher long-term interest rates; the exact opposite actually occurred.

As the following charts illustrate, the four major zones of the world (US, Japan, Europe and the UK) have increased their debt to GDP over the past 18 years. Simultaneously, interest rates have fallen in unison. Debt to GDP is expected again to increase in 2017 so interest rates are likely to continue their march lower. It strains credibility in our view to expect rates to rise given the historical data shown in these four charts.



Portfolio Allocations

We continue to overweight high-quality, longer duration bonds and have reduced exposure to US equities vs. our benchmarks. We also continue to avoid most traditional international equities given their exceptional debt loads, sluggish growth rates, and a strong dollar that will cause additional strains in the emerging economies. We will wait patiently for the US stock market to reflect more traditional valuations but as the quote above states, we are comfortable having been cautious over the years as the risks to the downside could reset the markets quite quickly as they have in the recent past.

PENNIALL & ASSOCIATES, INC.