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January 6, 2017 – ***The Big D***

We hope that this letter finds you well and that you and those you love had pleasant end-of-year celebrations. As 2017 kicks off there is surely much to discuss, as the last two months of 2016 brought significant changes to the many landscapes we monitor in our efforts to safeguard clients' assets.

Chief among these changes is a shift in the dominant market narrative surrounding the proposed fiscal and regulatory policies of Donald Trump. Seemingly overnight, market pundits changed their tune from expectations of a market collapse should Mr. Trump win to expectations of increased corporate profits and higher inflation. Without delving into the murky water of politics, as we have clients on both sides of the aisle and situated at many varying points along the political spectrum, we urge caution in buying into the current narrative. In this letter and in our coming conversations we will explain why.

Following what was at often times a divisive political campaign, we have a new President Elect with whom will undoubtedly come many changes to 'business as usual' in Washington DC. Since the November 8th election, after almost immediately recovering from the initial shock of the unexpected outcome, markets have been adjusting to the potential economic and geopolitical realities of soon-to-be President Donald Trump. Having been flat since the end of 2014, the S&P 500* and Dow Jones Industrial Average* jumped to new highs in the period following the election to finish 2016 up +9.5% and +13.4%, respectively.

The Dow actually logged the best performance from Election Day to year-end since Herbert Hoover won the election in 1928. As hedge fund legend Mark Yusko pointed out via Twitter this week, 1928 was a year in which the Republicans swept the election, ushering in a president-elect without any political experience, debt

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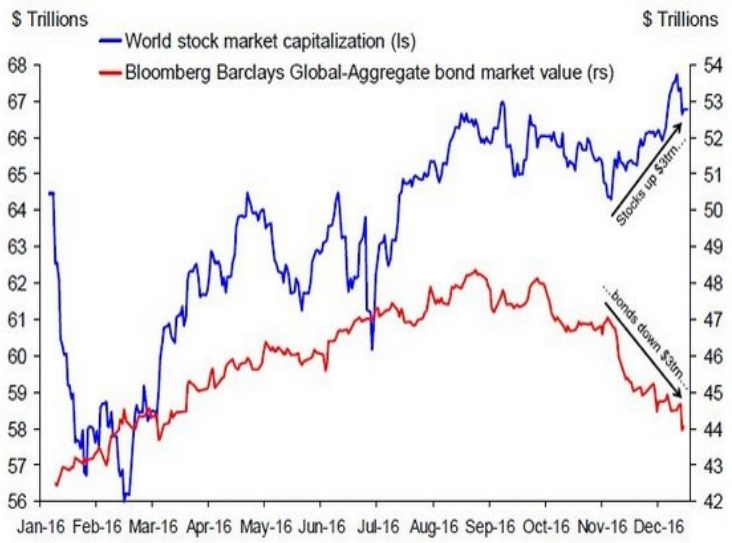
levels were massive, global trade was in decline and equity valuations were sky high. Does any of that sound familiar? Did anything of note happen in 1929? As Mark Twain is often misquoted as having said, history doesn't repeat itself, but it does rhyme.



Not only did the broader equity market give a vote of confidence to the Trump Administration's campaign promises of lower taxes, less regulation and increased infrastructure spending, the bond market and most yield-sensitive securities reacted unfavorably to the likely inflation and higher interest rates that would likely accompany such policies. Coupled with the expectation of a rate hike at the Federal Open Market Committee's (FOMC) mid-December meeting, fixed income yields jumped further and faster than they had since the 'Taper Tantrum' of 2013 as investors pulled money from global bond markets and dove head-first into equities.

According to independent equity research firm Trim Tabs, "US equity ETFs saw $97.6 billion in inflows between November 8th and December 15th – around 150% of the $61.5 billion that flowed into the category over all of 2015." Meanwhile, according to a December 20th article on CNBC.com:

> *Chief executives and other corporate insiders, whose personal and corporate coffers are supposed to fatten under the policies of President-elect Donald Trump, are dumping stock during this postelection rally while other investors are falling over themselves to buy into the 'Trump trade'. So who's the sucker?...*
> *There were nearly five insider sale transactions for every one purchase on the US stock market last week, according to Vickers Weekly Insider. That's nearly double the 2.5-1 ratio it takes for the firm to get bearish.*
> *"Insider sentiment continues to reflect apparent caution on the part of corporate executives, directors and beneficial owners, this as major equity indices hang near all-time highs but seem unable to muster the needed strength to push still higher," the Vickers report said.*

Could this be yet another example of ordinary Ma & Pa investors being sucked into the market at precisely the wrong time? Only time will tell, but many market historians have noted that the only thing this bull market has been missing to signify its imminent demise has been a blow-off top in which retail investors once again get left holding the bag. We may be in the midst of just such a situation.

At their mid-December meeting, the FOMC did in fact hike short term interest rates by 25 basis points (one quarter of one percent) to a target range of 0.50-0.75% and presented an expectation that at the end of 2017 the Fed Funds rate would be set in a target range of 1.25-1.50%. This suggests that they expect to hike interest rates three times this year, by the typical 25 basis points each time. We take this opportunity to remind readers that one year ago at their December 2015 meeting, at which point they raised rates for the first time since 2006, they anticipated economic conditions that would accommodate their raising rates four times in 2016. Just as we correctly predicted in last January's note, we suggest that the Fed will not be able to meet their stated interest rate objective this year, the reasons for which we will discuss below.

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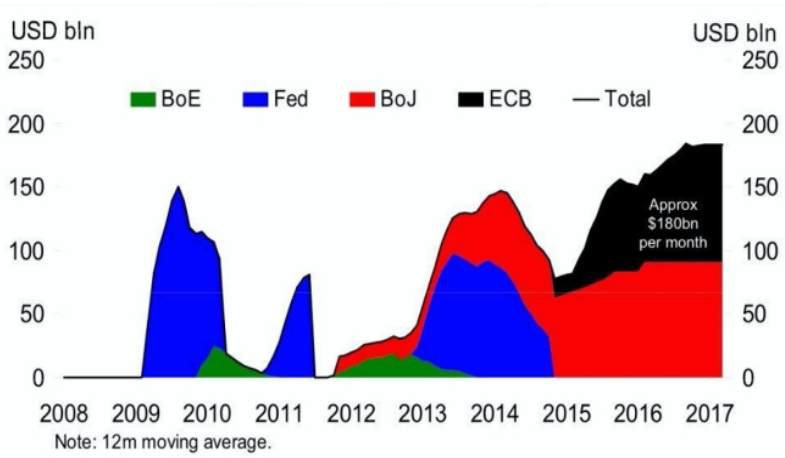

We have been vocal critics of the Fed and other central banks' reliance on Zero and Negative Interest Rate Policy (ZIRP and NIRP, respectively) as well as their repeated rounds of quantitative easing, in which they have electronically created 'money' out of thin air and used it to purchase securities in the open market. Despite the end of QE here in the US, central bank balance sheet expansion continues globally at its most aggressive monthly rate ever, thanks to the Bank of Japan (BOJ) and European Central Bank (ECB).

According to market analyst Sven Henrich "central banks' adding over $2.2 trillion in artificial liquidity a year exceeds the $1.7 trillion it costs to run all the militaries in the world… by over $500 billion per year!" That is a war on economic reality. To paraphrase Einstein, you can't solve a problem with the same level of thinking that created it. The problems wrought by low rates and excess debt won't be solved by more of the same.

Through the Fed and other central banks' injections of liquidity into global markets, asset prices have been artificially inflated, resulting in the misallocation of capital and allowing businesses and investments that would otherwise have been unprofitable and insolvent to carry on. We argue that the proliferation of such 'zombie' corporations adds to the deflationary effects of the larger secular issues behind the current lack of organic global growth: demographics, technology/automation and debt.

We have discussed at length in previous letters (all of which are archived on our website) the issues surrounding the monetary policies of global central banks as well as the deflationary effects of aging populations in the developed world. In a future letter we'll discuss the deflationary effects of advances in technology and automation. Were we not hampered by a desire to keep these letters readable in a single sitting, it would be germane to this conversation to discuss here how the Trump administration's desire to bring manufacturing back to America (which we believe can and will happen) will not necessarily result in a tidal wave of manufacturing employment.

The reason manufacturing jobs were lost in the first place was the cheaper relative cost of labor overseas. Businesses that are incentivized to move manufacturing back to the US, either as a result of new trade regulation or improved supply chain and distribution logistics, are likely to protect their bottom lines by utilizing the latest technology to produce their goods and services as opposed to employees who require training, health benefits and (as studies have shown is necessary with members of the Millennial generation) constant pats on the back for a job well done. Recent advances in automation and software will not only prevent the hoped-for return of low-skilled manufacturing jobs. A recent study out of Oxford University estimates that 47% of jobs in the US are at risk of being automated in the next 20 years. Not a cheery thought. Again, this is a topic for a future letter.

What we'd like to focus on this time around is the 'Big D' referenced in the title of this letter: Debt. The Institute for International Finance recently reported that total global debt rose to $217trillion in 2016, more than 325% of the world's GDP. Debt is the third leg of the deflationary stool that we believe is the culprit behind the lackluster recovery from the GFC and is likely to hamper the expected growth that has been priced into equity markets since the election.

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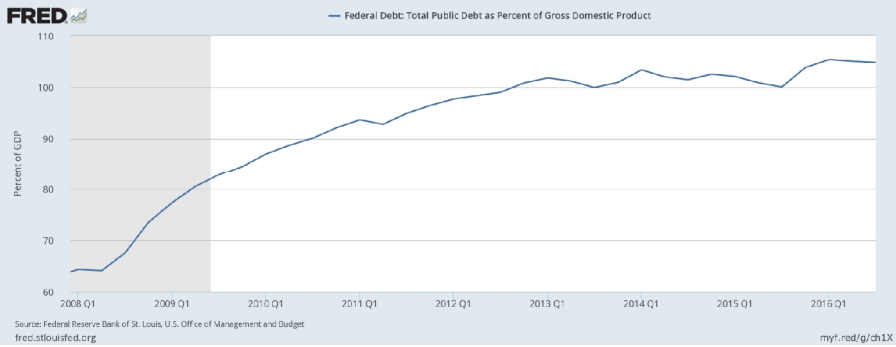
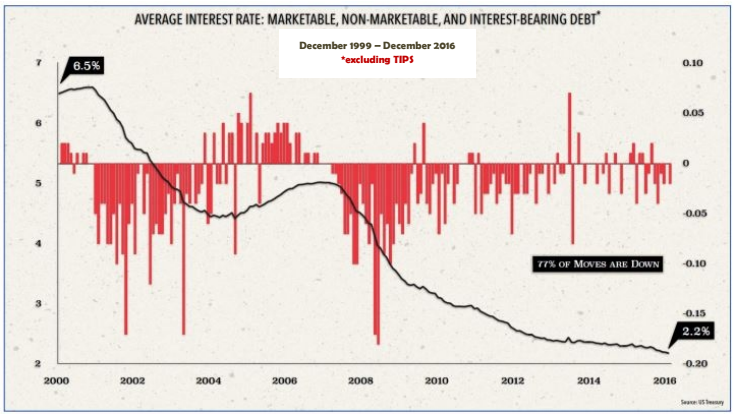
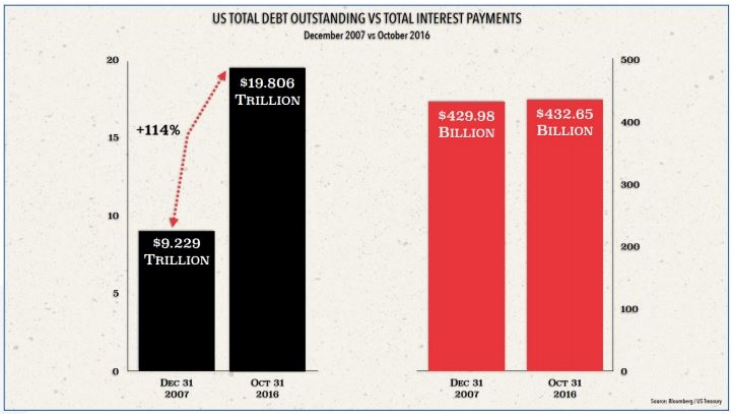
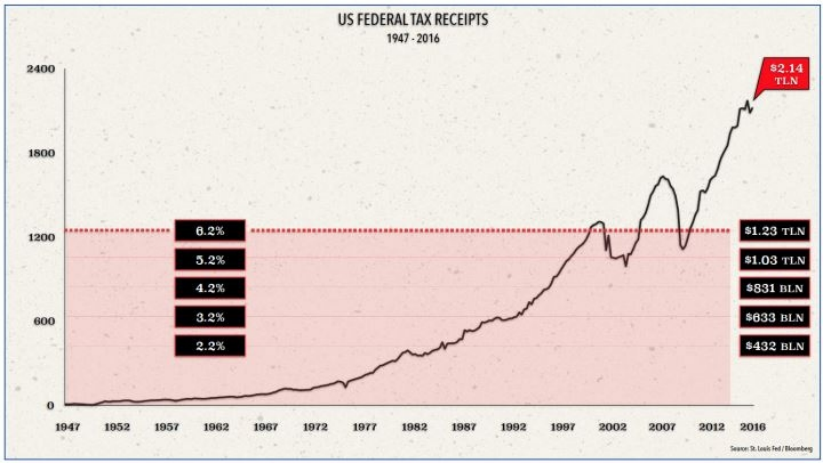
Unfortunately for those who are envisioning the return of 4-5% GDP growth over the next several years, with that higher growth rate would also come materially higher interest rates. The portion of the mandatory federal budget allocated to debt service in that scenario would blow up the deficit, adding to the total debt needing to be serviced and crowding out other non-discretionary spending. That is before factoring in the additional debt related to unfunded fiscal stimulus (i.e. infrastructure investment) or revenue reducing tax cuts, which have not historically paid for themselves according to the independent Urban-Brookings Tax Policy Center.



As the above chart from the Federal Reserve Bank of St. Louis shows, the total US Federal Debt-to-GDP ratio ballooned from 64% to 105% in the last eight years. Interestingly, because the average rate of interest on federal debt fell during that time period from 4.65% down to 2.18%, the annual cost to the federal government to service that debt barely budged. As seen in the bottom of the three charts below from Grant Williams of *Real Vision TV*, if the average borrowing cost rose from the current 2.2% to the historic average of 6.2% the cost to service the debt alone would eat up more than 50% of the most recent year's tax receipts.







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It's not just the federal government who is unprepared to stomach materially higher interest rates. The below quote and chart come to us courtesy of institutional research firm 720Global:

> *Investors and the market as a whole are failing to consider the importance of the confluence of the highest debt levels (outright and as a percent of GDP) and the lowest interest rates (real and nominal) in the nation's history. Because of the magnitude and extreme nature of these two factors, the economic sensitivity to interest rates is greater and more asymmetric now than it ever has been.*

720GLOBAL

1980	Total ($billions)	Per Household ($)	As % of Household Median Income
Federal	931.39	11,642.39	24%
State/Local	342.78	4,284.79	9%
Total	**1,274.17**	**15,927.19**	**33%**
Mortgage	1,452.15	18,151.88	37%
Revolving	127.75	1,596.89	3%
Student Loan/Misc	230.11	2,876.42	6%
Total	**1,810.02**	**22,625.19**	**46%**
Total Govt and Personal Debt	**3,084.19**	**38,552.37**	**79%**

720GLOBAL

2000	Total ($billions)	Per Household ($)	As % of Household Median Income
Federal	5,638.07	53,695.89	102%
State/Local	1,415.68	13,482.66	26%
Total	**7,053.75**	**67,178.55**	**128%**
Mortgage	6,730.61	64,101.09	122%
Revolving	679.77	6,473.98	12%
Student Loan/Misc	1,029.77	9,807.32	19%
Total	**8,440.15**	**80,382.39**	**153%**
Total Govt and Personal Debt	**15,493.90**	**147,560.93**	**280%**

720GLOBAL

2016	Total ($billions)	Per Household ($)	As % of Household Median Income
Federal	19,939.60	160,028.86	283%
State/Local	3,106.94	24,935.28	44%
Total	**23,046.53**	**184,964.14**	**327%**
Mortgage	14,315.54	114,891.95	203%
Revolving	984.72	7,903.07	14%
Student Loan/Misc	2,766.39	22,202.17	39%
Total	**18,066.65**	**144,997.20**	**257%**
Total Govt and Personal Debt	**41,113.18**	**329,961.34**	**584%**

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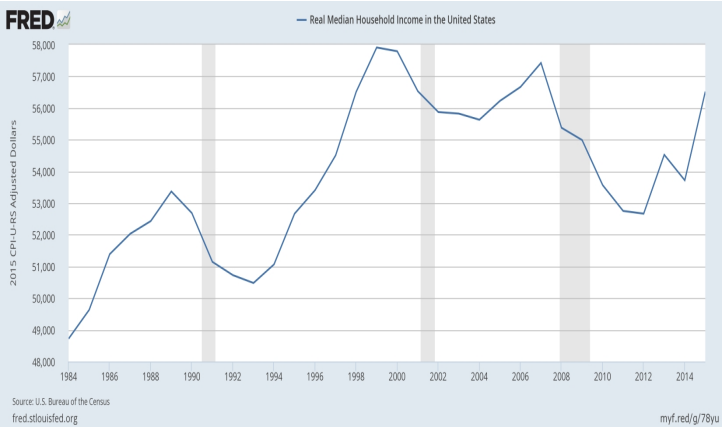
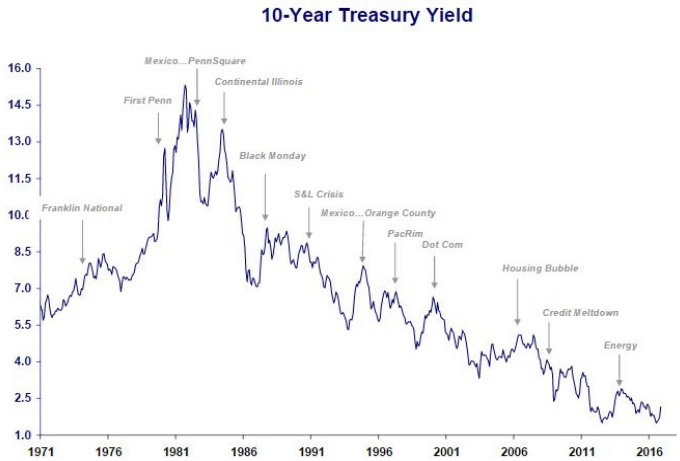
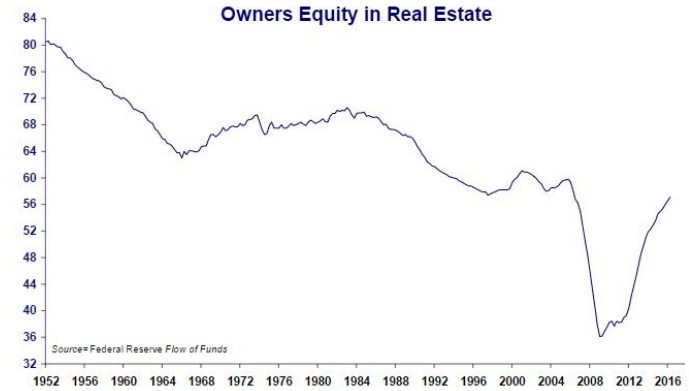


It is interesting to note that 720Global quantifies these debt loads relative to Household Median Income. As we have noted many times previously, real household median income topped out near the tail end of the bull market and economic boom of the 1990's and has failed to reach its prior peak in each of the last two post-bubble expansions. We'll leave it to the political scientists to squabble over what has led to the rise in populism both here and in Europe, but we'd wager that almost two decades of stagnant wages for the middle class may have something to do with it.

The rock-bottom interest rates of the past eight years have helped corporations and households reduce or contain their debt service costs. Rapidly rising rates, as foreseen due to both the Fed's stated objectives and the Trump Administration's policy goals, would hammer those in the middle class whose inflation adjusted incomes have not risen, many of whom are barely scraping by as it is. The following quote and charts come from a recent note by economic analyst Stephanie Pomboy at MacroMavens:





As for the economy, the idea that we can handle a backup in interest rates of any real magnitude is roundly impugned by the chart [top left]… For contrary to popular perception, there are many folks exposed to a near-term rise in rates. The majority of households may have shrewdly refinanced their mortgages multiple times over, but a large swath haven't had that opportunity. ***Some 12.2million households (24% of the total) are still languishing in negative equity.*** *And it wouldn't take much for a lot of folks to rejoin these sorry ranks. The homeowners' equity ratio, at 57%, still isn't back to its pre-bubble bust levels – which at the time were RECORD lows! [bottom left] Importantly, that figure includes the 36% of homeowners who own their homes free and clear. Adjusting for them,* ***the equity position of the folks who DO have a mortgage is just 33%.***

The modest uptick in mortgage rates since this summer has already caught borrowers in the crosshairs. [Editor's note: the average rate for a 30-yr mortgage in the US has risen from 3.42% in early October to 4.32% at year-end] *According to RealtyTrac, foreclosures surged +27% in October – the largest one-month gain since August 2007… And then there's all the folks who took out HELOC's at the peak of the housing bubble who are now coming up on their 10-year reset phase. Some 840k of these loans reset [in 2016], spurring a rise in delinquencies from 2.2% to 4%. The fact that those delinquencies came* ***before*** *the dramatic backup in rates we've seen post-election doesn't bode well for the* ***one million HELOC's that are slated to reset in 2017.***

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The debt that we've mentioned above does not even take into consideration the unfunded pension liabilities of federal, state and local governments. In our last letter we touched on the perfect storm that is brewing in this country's pension system. Stanford University's Pension Tracker database tallies total unfunded US Pension debt at $5.6 trillion, which is roughly $47,388 per US household. California alone, which is home to the largest state pension system in the country, California Public Employees' Retirement System (CalPERS), has pension debt of approximately $1trillion, or $93,000 per California household.

CalPERS' board recently voted to gradually reduce over the next several years the assumed rate of return of its investment portfolio from 7.5% to 7.0% in an effort to more accurately reflect the global investing environment. Based on current sky-high valuations of nearly all investable assets following eight years of central bank largesse, even that 7.0% average rate of return is going to be extremely difficult to come by over the next decade. According to Bloomberg, in the fiscal year ending June 30, 2016, the fund's investment return was +0.6%, dropping its 10-yr average return to +5.1%. Over time, the underperformance of any state pension system's investment portfolio must be made up out of the state's coffers (i.e. by taxpayers) or the benefits promised to retirees must be renegotiated, which makes for a very touchy political situation.

Taxpayers' liability for state pension shortfalls is going to be a major issue in coming years. In just the past month this issue struck in another 'Big D', as the Dallas Police and Fire Pension system suspended retirees' ability to take lump sum withdrawals after concerns about the fund's solvency sparked a deluge of withdrawal requests. From *Pensions & Investments* magazine, January 3, 2017:

> *Segal Consulting, the [Dallas Police and Fire] Pension system's actuary, projected in July that the pension fund would become insolvent in 2030, absent any changes to benefits or contributions. A record $523 million in withdrawals from the pension fund's Deferred Retirement Option Plan (DROP) since then has moved that date closer to 2027.*
> *The pension fund board voted Dec. 8, to temporarily suspend DROP withdrawals, a few days after [Dallas Mayor] Mr. Rawlings filed a lawsuit against the pension fund for making DROP payments while its finances were strained.*

The auditor's projected insolvency date of 2027 assumes the fund is able to achieve its expected rate of return of 7.25% between now and then. It's no wonder beneficiaries were scrambling to get what they could.

There is no easy way out of the situation in which the global economy finds itself. The medicine initially prescribed by the world's central banks following the Global Financial Crisis has morphed into an albatross around our necks. Years of ZIRP, NIRP, QE, the piling on of household, corporate and public leverage (debt) and the inevitable misallocation of capital prompted by such leaves us balanced on a high wire from which the slighted fiscal or monetary policy miscalculation could have us tumble.

Again, from 720Global:

> *In an eerie parallel to the years leading up to the crisis of 2008, hundreds of billions of dollars of investors' capital is being jack-hammered into high-risk, fixed income bonds and dividend paying stocks in a desperate search for additional yield. The prices paid for these investments are at unprecedented valuations and razor thin yields, resulting in a tiny margin of safety. The combination of high valuations and low coupon payments leave investors highly vulnerable.*

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German Chancellor Angela Merkel, who *Forbes* recently named the third most powerful person in the world (interestingly, behind Vladimir Putin at #1 and our very own Donald Trump at #2), recently said "In 2016, the world has not become stronger and more stable, but weaker and more unstable." We would tend to agree.

Markets continue to be priced for perfection. Delays in fiscal policy approvals or mistakes in executions (not to mention ill-advised Tweets) could ding market expectations and quickly return equities below the pre-election levels illustrated on the first page of this letter or below. We continue to urge extreme caution with portfolio allocations and recommend an underweight to equities and an overweight to cash. As illustrated in the 10-year Treasury yield chart from Stephanie Pomboy on page six, spikes in treasury rates have historically preceded economic and financial crises and we think now is an excellent opportunity to add to current treasury allocations in advance of a potential repeat of history.

We will close with a comment from noted economic analyst John Mauldin:

> *Government mistakes are a top risk factor now… We have an incoming government that will likely try things no one has ever tried before. We have a Federal Reserve that needs both to raise interest rates and to reduce its bloated balance sheet [in preparation to fight the next recession]. We have all kinds of international challenges…*
> *We enter 2017 with more question marks than I can count. Even if all the policymakers are competent and have good intentions, stuff happens. Things go wrong. People don't react the way you think they will. You end up causing more problems for the people and businesses you wanted to help.*
> *I have full confidence in the ability of US businesses to produce quality products and services at fair prices. Ditto for many other countries. Their decisions are not what we need to worry about. Now, more than ever, economic risk around the world emanates from governments and central banks.*

Please feel free to share this newsletter and do not hesitate to call or email with any questions or comments or to schedule a face-to-face portfolio review.

Sincerely,

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