INVESTMENT OUTLOOK

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Strategic Frontier Management
Fourth Quarter 2016

RUTHLESSNESS OF UNRULY FORCES

- Investors want to know what matters most and how markets will respond to recent geopolitical events, including the U.S. election, as well as upcoming European elections and the Italian referendum. Many citizens are concerned about what the surprising change in leadership will mean for a nation that has been divided for years. However, the shift in the balance of power had a constructive impact on our economic and earnings forecasts. We expect increased potential growth, rising from 2.0-2.5% to 3% with greater productivity given expected policies. Rising inflation will accelerate interest rate normalization. The fiscal deficit can moderate with stronger growth. Investors seem to agree given recent response of equities, bonds, and U.S. dollar.

- Corporate and individual tax reforms, combined with targeted deregulation, are among top priorities of Congress and the new Administration. Rolling back some portion of nearly 500 Executive Orders or Memoranda will have an impact by Spring 2017. Loosely written legislation increased dependence on complex agency rulemaking and interpretive guidance are subject to revision after transition. Thus, there are many ways to affect policy change relatively quickly. Most politicians tackle issues one at a time---we expect this Administration and Congress will tackle many issues at once. Political status quo has been disrupted by *Ruthlessness of Unruly Forces*, so be ready for substantial changes.

- Experience suggests effects due to shifting balance-of-power usually lag significantly, but consequences of this election are likely to have more immediate economic impact. While actual policy changes are uncertain, change elections suggest an implicit mandate and the direction is clear. Alignment of political control is unusual, but can result in the greatest changes in the least time.

- Greater infrastructure investment is likely but how it could be financed is widely misunderstood. Should heavily indebted governments borrow to fund infrastructure spending or let eager investors finance investment opportunities? Alternative private external financing of infrastructure can increase investment capacity at lower taxpayer cost. We can't spend our way into enhanced productivity any more than we can tax an indebted society into prosperity.

- Global interest rates are expected to rise, led by rate hikes in the United States. Investors need to be vigilant about the impact on rate sensitive holdings, even within private markets. Emergency monetary policy is no longer needed, so investors must focus on the consequences of monetary normalization, including winding down bond holdings. Expect steady ¼% interest rate hikes every other FOMC meeting or 1% per year to at least 3.5%. Treasury 10-year bond yields need to rise above 5%. A three decade long bond bull market led investors to adopt unrealistic bond risk and correlation. Persistent losses should increase the inflation risk premium.

- Our global tactical asset allocation models favor overweighting U.S. equities with a small-cap tilt, while underweighting U.S. and U.K. bonds. Resilient high profit margins should support equities and drive earnings growth, while interest rates normalize with a continued strong U.S. dollar. We are concerned that low volatility and high dividend yield strategies could be vulnerable. Financial and Industrial companies, including Defense, should benefit most in this new regime. Currency and interest rate volatility should increase with global economic divergences, but expect increased volatility-of-volatility for equities. Secular and cyclical changes expected are significant for investors, and we expect profound divergences across risk factors, while observing evolution in risk measures, including volatility and correlation.

Age of Anxiety and Uncertainty

Unexpected outcome of U.S. Presidential and Senate elections rocked the status quo, hurling geopolitical shockwaves for the second time in several months. A coalition of *Reagan Democrats* (Trump Independents) and a *Silent Majority* emerged seeking to restore liberty, free markets, and government restraint. The election also exposed the extent of a significant ideological divide, not only between political parties, but also within them. Extreme regional geographic differences are notable and seem to be increasing. In spite of tremendous economic experimentation, the theory on how the *economic machine* works and even the objectives of government are still being debated.

The *Age of Anxiety* is a consequence of persistent economic uncertainty and periodic exogenous events, such as BREXIT (U.K. leaving the European Union.) and the *Republican Sweep* at both the national and state level. Many strategists expected geopolitical uncertainty in both cases to drive equity selling, but investors still perceive value in equities with indices climbing to new highs. However, the rise in Treasury yields appears attributable to shifting investor views on hiking interest rates faster. Prior to the election, no more than a 0.5% increase to 1% through 2017 was expected, but expectations are more aligned with our 2017 forecast of 1.75%, beginning with a December 2016 hike, followed by every other meeting thereafter.

Our greatest concern is excessive outstanding global debt with record pension asset allocations exposed to interest rate risk and overvalued bond markets. Risk parity and other portfolio risk allocation schemes that drove higher bond holdings have exposed investors to a rotation from bonds. Countries with negative interest rates could find a bond reversal challenging to public pensions and fiscal deficits. Rising interest rates may reduce the accounting present value of future pension liabilities, but negative real bond returns undermine return objectives, particularly for underfunded plans. Leveraged and very long duration bond portfolios increase systemic financial risk. As the Federal Reserve hikes interest rates, global bond yields will be dragged higher, resulting in persistent losses.

Intermittent periods of equity volatility result in greater volatility-of-volatility, but the average isn't higher than historically observed. This can provide tactical hedging opportunities for disciplined asset owners, instead of costly buy-and-hold or increasing stop-loss practice (akin to portfolio insurance).We do expect bond and currency volatility to increase as interest rates rise and global economic divergences increase.

Economic Observations

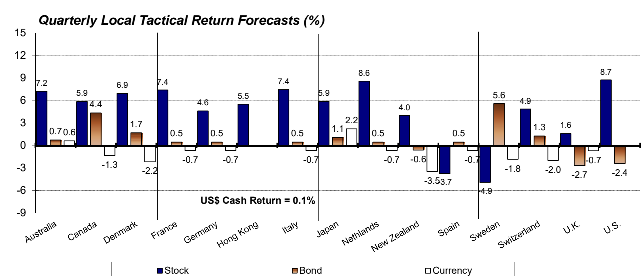
The global economic recovery has extended more than seven years, but economic cycles don't run on a clock, even if risks to its durability seem to be increasing. The U.S. economy expanded just 2% for the last two years, but we believe it can accelerate in 2017 given pro-growth policies expected to be enacted. We upgraded our growth, inflation, earnings, and interest rate forecasts as a result of the U.S. election. Our outlook is not typically responsive to political change because lags are generally so long, but for reasons described below, this election can yield a meaningful policy inflection point over a relatively short time horizon.

Forecasts below suggest growth will accelerate with fading cyclical and regulatory headwinds, although mindful of the inflection point in normalizing interest rates. Global growth languished this year but economic differences will increase as monetary and fiscal policy diverges. After considerable reflection, we highlight our critical forecast changes, increasing real growth, earnings, and inflation through 2018. Probability of U.S. recession, which was increasing for 2018, has been forestalled. Our confidence improved with regard to stock, bond and interest rate forecasts.

Economic Forecasts	**2012**	**2013**	**2014**	**2015**	**2016e**	**2017e**	**2018e**
GDP Growth (Y/Y Real)	2.3	2.7	2.5	1.9	**2.1**	**2.5**	**2.7**
S&P500 Earnings	6.0	5.7	8.1	-0.9	**1.3**	**10.9**	**13.6**
CPI Inflation (Y/Y)	1.8	1.8	0.7	0.7	**1.7**	**2.5**	**2.7**
Unemployment	7.8	6.7	5.6	5.0	**4.9**	**4.8**	**4.5**
Fiscal Deficit	-6.6	-3.2	-3.5	-3.0	**-3.8**	**-3.5**	**-3.0**
Fed Funds Target	0.25	0.25	0.25	0.50	**0.75**	**1.75**	**3.25**
10y Treasury Notes	1.85	3.00	2.17	2.27	**2.50**	**3.50**	**4.75**
S&P 500 Target	1426.	1848.	2059.	2044.	**2150.**	**2350.**	**2500.**

Source: Strategic Frontier Management

Our global tactical models are still forecasting strong global equity returns, let by U.S. equities with a small-cap tilt. Continental European equity returns should also be above average, but U.S. and U.K. bonds are overvalued and negative returns are forecasted. The U.S. dollar should strengthen further.



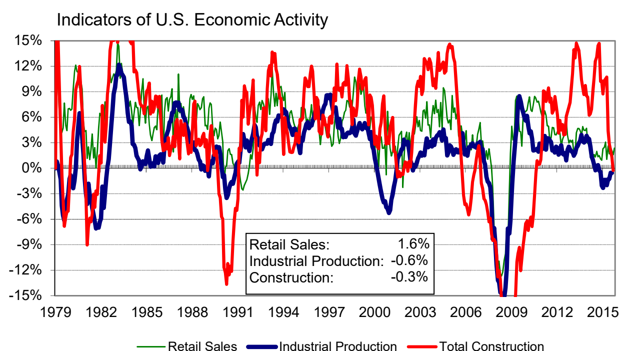
Global bond yields are so low, even negative in Japan and Europe, that investors must appreciate the effect of high bond convexity[1] that increases interest rate sensitivity at low interest rates. Leverage and extended bond duration will amplify losses as bond yields rise. In other words, investors likely will be surprised by larger bond losses then assumed for a 1% change in yield.

[1] Bond convexity is a measure of changing bond return sensitivity to changes in interest rates, specifically the second derivative of bond price with respect to interest rate changes.

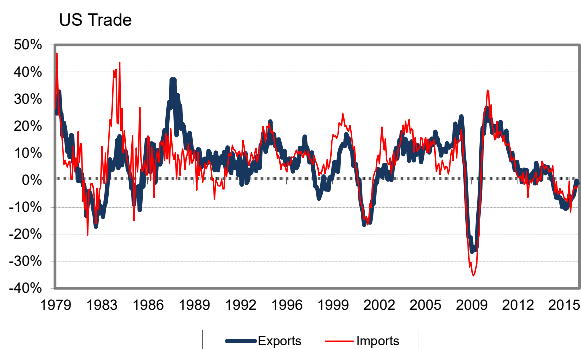
It is helpful to decompose economic growth in smaller intuitive pieces. Many economists rely on the following decomposition to describe economic growth:

Growth = Consumption + Investment + Net Trade + Gov't
= Workforce Growth + Productivity

These relationships help describe the cyclical forces driving economic growth. We expect key drivers of economic growth in 2017 will be housing, investment, and export growth. Consumption has carried the economy, but there is pent-up demand for capital investment, held back by business anxiety, and construction with a scarcity of new homes. Infrastructure spending may contribute, but industrial production and construction weakness is concerning. The second equation highlights the economic importance of productivity and job growth.



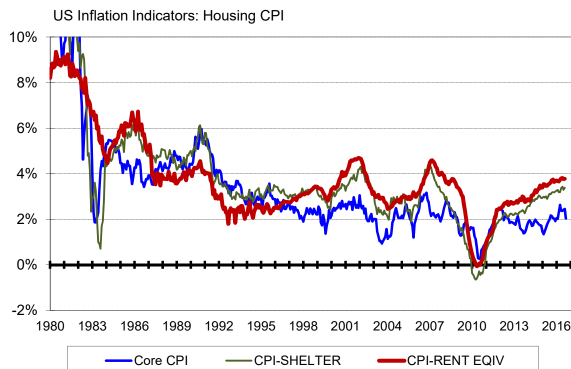
Long ago we learned that *The World Is Flat* (Thomas Friedman, 2005) with the convergence of technology and globalization—these forces cannot be contained. Faltering competitiveness tends to undermine productivity and exports. Any short-lived benefit from manipulating currencies to gain a competitive edge is only transitory and costly to defend. Declining exports have troughed, but concern about jeopardizing trade during a Trump Administration overlooks regrettably weak exports since 2012. U.S. export growth declined below its 35 year average of 7.2%, but focus on trade balances tends to mask this issue. Decomposing net trade into imports and exports is interesting for countries that run large trade deficits, like ours.



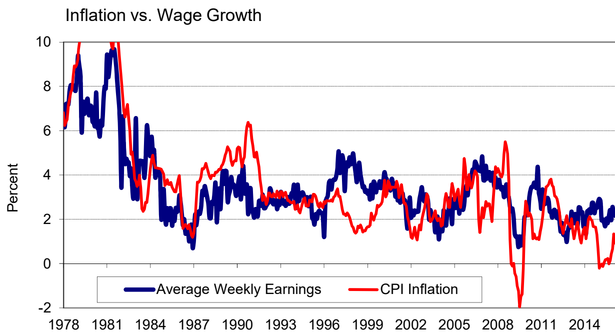
Our economy has become more oriented toward services. Labor intensity in manufacturing and construction has declined with an emerging *Industrial Renaissance*. More jobs are being replaced by fewer employees resulting in difficult shortages for some skills and a glut for others. Excellence in software, semiconductors, logistics, simulation, robotics, rapid prototyping, sensors, and virtualization has boosted productivity and profit margins. New revenue models cause measurement issues that seem to understate growth and productivity. Widespread commercialization of disruptive and adaptive technologies had a disinflationary impact on costs and resource utilization. It has accelerated turnover of investment themes and increased *Ruthlessness of Unruly Forces* to retain sustainable competitive advantage.

Deflation risk seems to be a symptom, not a cause of weaker growth. Faltering competitiveness can result from poor policy decisions. Heal the disease, and the symptoms will be addressed. It has seemed expedient to exploit aggressive monetary policy for an extended period, but symmetric targeting of inflation has never been tested. Central banks typically intervene when inflation rose too fast or in recession, but intervention was never attempted to boost inflation. Risk of extended stagflation has become worrisome.

Secular disinflationary forces can be attributed to globalization, outsourcing, innovation, lower labor intensity, hyper-competition, and Internet price transparency, which helped keep inflation contained. These factors bolstered higher profit margins for the last decade. Declining prices in basic resources masked underlying inflation, but commodity price effects are sunsetting. Labor costs and housing have not been dormant, as evident in core consumer prices (CPI ex-food and energy). Housing is 42% of core CPI, which has behaved quite different than CPI inflation.



Average wage growth has exceeded 2% since 2010, despite misleading concern of declining household incomes. Cost of living increases ensure this is true. Salary cuts are scarce, even if inflation dips negative, but we see that even CPI inflation is now rebounding.



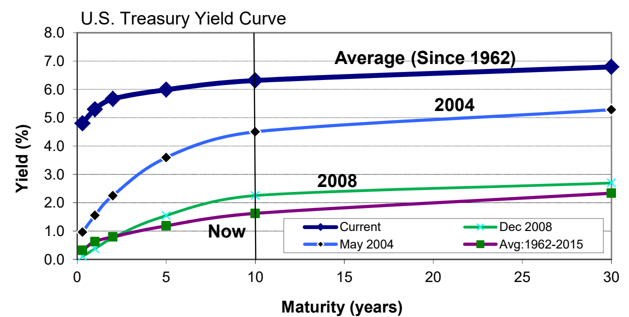
Investors looking to hedge inflation risk gravitate toward real assets, commodities, inflation protected securities (TIPS), or other alternatives. Commodities, including gold, have lower correlation with inflation and higher volatility than investors assume, while lacking long-term upside beyond inflation. Financial exposures soared over the last decade, pricing many commodities higher than the marginal cost of production. They may also compete with cheaper engineered substitutes. Financial investors now overwhelm physical holders by accessing new avenues of liquidity (ETFs and futures). Meanwhile, exploration, extraction, and enrichment costs are falling due to technological and process improvements, which also increased recoverable reserves. We believe Commodity Supercycle highs are unlikely to be revisited in the next decade. Liquid alternative allocations continue to disappoint with relatively high fees and limited long-term value.

Gold behaves like a currency with no identifiable risk premium, struggling to keep up with inflation over the long-run and volatility exceeding equities. A 36% decline in the value of gold during 2013-2015 with high volatility has finally led investors to question its worth as a strategic allocation. Gold can't be both an inflation hedge and a safe haven against deflationary collapse. The 2016 rebound in gold is a false dawn for real assets---gold is a terrible strategic allocation, but even as a tactical hedge, few investors ever capitalize on short lived spikes in price. The most underappreciated liquid hedge to reduce portfolio volatility is cash and short-term bonds.

Perils of Moral Hazard

Central bank monetary intervention has included manipulating policy interest rates, forward guidance, and accumulating bond holdings globally. The peril of this explicit moral hazard is evident in the decisions of investors, businesses, and households. They expected exceptionally low interest rates for an extended period to bolster consumption and discourage savings. Aggressive monetary policy can be effective in the short-run, for example during the Financial Crisis, but has proven ineffective over longer horizons. Excess bond holdings and extremely low interest rates will be challenging to unwind without limiting credit growth. After holding down interest rates for seven years, yield curve normalization should result in negative real bond returns until 10-year Treasury yields exceed 4.0%. The inflection point in global interest rates is of great significance to investors.

We have enjoyed low inflation, particularly for imported goods. However, central bank preoccupation with symmetric inflation targeting is misguided—it is a fool's errand and risks greater bond market volatility in years to come. Below is one of our more helpful charts that highlight the normalization of interest rates. Raising interest rates to 2% would still be stimulative, yet more consistent with the prudent Taylor Rule. If 10-year Treasury bond yields rise to our target of 3.5% in a year from 1.7%, that implies a return of -12.8%.



Global bond debt has reached unimagined levels even as central banks and yield-starved investors clamored for bonds. Unwinding central bank holdings will crowd out needed corporate, mortgage, and municipal debt issuance for years to come. Current holdings of $1.4 trillion will mature within the next five years, but fiscal deficits require more Treasury issuance. Governments are still spending well beyond their means, and ignoring lessons of how quickly tipping points emerge. Academics dismissing consequences of unsustainable fiscal deficits only seem to reinforce imprudent spending. Low rates reduced interest expense, even as debt increased, but eventually bonds must be rolled, which compound debt burdens as interest rates rise.

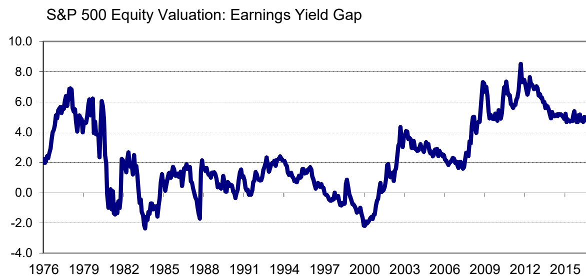
Still underfunded global pension funds are more exposed than ever to interest rate sensitivity with leverage and extended bond duration that could compound losses, despite intending to minimize downside risk of "accounting" liability. Pension funds that increased bond exposure by embracing LDI, risk parity, and other de-risking strategies should be impacted most by rising interest rates. Strategic asset allocations with reduced equity and record bond exposure will struggle to achieve return objectives. Endowment plans may also be unable to support 4-5% spending rates given their extreme allocations to high cost alternative investments. Our concern is whether investors appreciate their interest rate sensitivity, particularly in alternative investments.

The longer it takes to normalize market rates, the more likely a bond market correction resembles 1994, rather than 2004. Inflection points can trigger systemic issues. Orange County's bankruptcy was triggered by rate hikes affecting a 1.5X leveraged bond portfolio, but we believe the risk could be 10-100 times greater today. Dodd-Frank regulations limiting principal market making of bond trading could exacerbate a debt crisis.

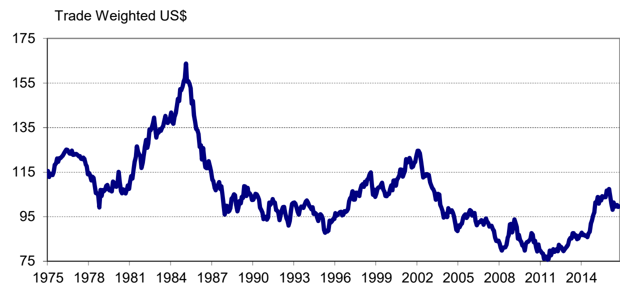
Japan's missed opportunity failing to fire the third arrow of Abenomics leaves fewer options to bolster their stalled economy with so much debt, hoping central bank stimulus would be sufficient. It is difficult to imagine how Japan can overcome deflationary forces, unsustainable deficits, and unmanageable debt. Suggestion that the Yen is a safe haven with increasing risk of a sovereign debt crisis is beyond our comprehension. Japan's largest public pension fund (GPIF) and Post Office Savings Plan are rotating out of bonds and increasing international investments, at the expense of Japanese stocks, bonds, and currency.

Capital Markets

The challenge for balanced portfolios will be persistent negative real returns of bond allocations---this could result in *Ruthlessness of Unruly Forces* boosting the inflation risk premium by 0.5% over a 2.5% normal 10-year Treasury spread, which is currently -0.7%. That represents significant steepening of the yield curve (bond vs. cash yield). Risk measures of correlation and volatility are evolving more quickly now, so the uncertainties of such risk measures should increase, as well. Traditional 60/40 strategic policy mixes have performed well over the last decade. Private market, hedge fund, and alternative allocations failed to deliver better return or lower risk. Safe havens such as high dividend yield, low volatility, consumer staples, utilities, and gold are particularly vulnerable to correction.



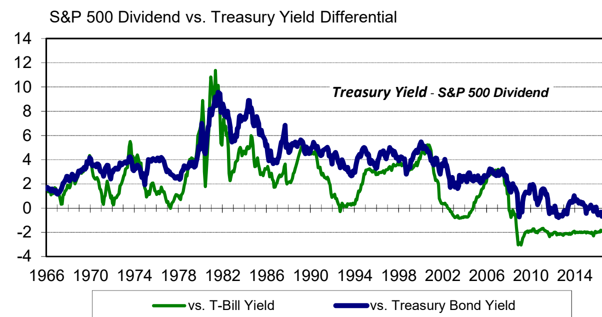
Volatility of currencies has been very low for years, so many currency managers have exited just before it started to get interesting. The U.S. dollar strengthened from 2011-2015 given fundamentals of stronger real growth and a lower fiscal deficit relative to other developed countries---Canada and Australia are notable exceptions. Misguided talk of the U.S. dollar losing its reserve currency status has finally quieted.



Since the Financial Crisis trough on 03/06/09, the S&P 500 has returned over 230%. However, equity valuations based on earnings, book value, or dividends remain quite compelling, particularly in contrast to exaggerated levels of 1987 or 2001. Shiller's CAPE tells a different story, but has been a lousy tactical valuation indicator for reasons we discussed before.

- **Overweight U.S. equities** favoring a **small-cap** tilt.

Low volatility and high dividend yield equities are expensive and should underperform as interest rates rise, but an important reason tax-advantaged dividend yield tilts outperformed is clear in the chart below. Bond yields are usually much higher than dividend yields.



Real estate, infrastructure, and other income producing alternative assets have gotten more expensive as yield seekers increased demand for these bond alternatives.

New Economic Frame of Reference

Congress with a strong House majority will dictate America's legislative agenda, unencumbered by threat of veto. Several key themes are apparent that will drive fiscal, tax, monetary, energy, health, labor, and security policies. We can't remember when the national agenda was so broad. Below we highlight observations within specific agencies that could be relevant to investors.

- **SEC** vacancies, including Chairman White leaving in January before her term expires, will impact critical financial market rules and regulations under review, regardless of Congressional action on Dodd-Frank Financial Reform.

- **Federal Reserve** Dr. Yellen's term as Chairperson of the Board of Governors expires in January 2018,

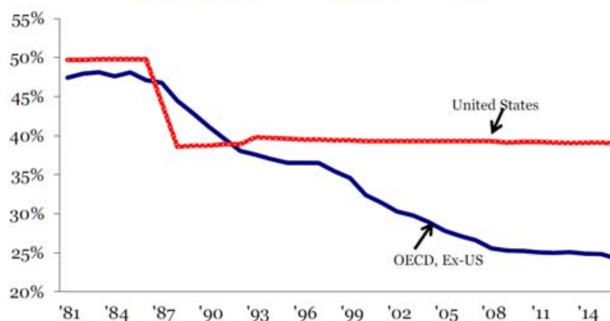
and is unlikely to be reappointed. There are two vacancies currently, and she is unlikely to serve the remainder of her term, expiring January 2024. Thus, three of seven Board members may be appointed in 2017, including a new Chairman.

- **Department of Labor** released a new *Fiduciary Rule* for managing retirement accounts, highlighting the importance of federal agencies setting policy. Expect changes to this rule, as well.
- **National Labor Relations Board** has two vacancies to fill, thus increased respect for state right-to-work laws.
- **Department of Education** will revisit Common Core, likely returning curriculum control to states and local school boards. The Department may be reduced in size, if not subsumed by another agency. Treasury can manage Student loan programs.
- **Internal Revenue Service** has been criticized for corruption, mismanagement, and technological ineptitude, including identity theft, fraudulent filings, and stolen records. Overhaul of the IRS is required to restore integrity and should be downsized with tax code simplification.
- **Supreme Court** vacancy should be filled before the next term and one other justice might be appointed.

Free market competition is always a better solution than imposing regulation to codify morality or fairness. Appointed agency heads have major influence on policy, so we can expect notable rulemaking and regulatory changes in 2017. Confirmation of over 1,100 Presidential nominees should be speedy.

Healthcare insurance was reasonably affordable a few years ago, but Obamacare premiums have increased 20-30% a year with even higher deductibles. This also drove up the cost of employer insurance faster than ever. This is problematic if consumer inflation remains below average, but inflation is accelerating now. The Affordable Care Act has failed and desperately needs to be fixed with tort and administrative reform, while increasing competition. We prefer **biotechnology** and **pharmaceutical companies** over health care insurers.

Corporate tax reform is needed to simplify the tax code and flatten tax rates, which can restore entrepreneurial incentives. Lowering taxes on foreign earnings repatriation will boost tax revenues, while simplifying the tax code reduces administrative and enforcement costs, as well as minimizing tax avoidance strategies. Over two decades, the international average corporate tax rate has fallen from 39% to 24%, while the comparable U.S. statutory tax burden has been stable around 39%, including a static 35% federal rate.



Source: Strategas Research

Widening tax rate differentials increased frequency of tax inversions, which Treasury sought to forestall by issuing a new tax ruling following Pfizer-Allergan's announced merger. Reducing corporate tax rates to 25% or less should reduce appeal of inversions and increase repatriation of foreign earnings, which can bolster investment. Tax code simplification should minimize tax avoidance, as well as administrative and enforcement costs, while curbing influence of special interests. Campaign objectives sought a 15% corporate tax rate while eliminating most business deductions, but bipartisan support for a 25% tax rate is evident. A recent House bill in June provided for a 20% tax rate.

- **Overweight Industrials**: Greater investment and infrastructure spending can bolster construction. Onshoring production and improving competitiveness enhance demand for capital equipment, while improving national defense and domestic security could provide a boost to **Defense**.

Congress will probably seek individual and estate tax reform, including flattening tax rates and simplifying the complex tax code. The tax code tripled in the number of pages since 1986, and estimates suggest that IRS administrative and compliance costs exceed $420 billion/year (ref: Tax Foundation & CBO, not including state costs). Recent House legislation proposed collapsing individual tiers to three with a top marginal tax rate lowered to 33%, reduced deductions, and eliminated estate taxes.

Simplifying tax reform can bolster growth and reduce administrative cost to deliver more sustainable fiscal balance to a notably dysfunctional system. Complexity breeds inequity, special interests, and high administrative costs—many taxpayers pay close to the highest marginal tax rate, while others with similar income end up paying much lower rates. This is where a real battle for tax equality exists. Warren Buffet sought to highlight tax rate inequity compared to his secretary, but it was misleading to confuse his ownership of Berkshire Hathaway taxed at 35% with his individual tax rate based on a salary of just

$100K/year, plus passive income taxed at 20%. Tax avoidance is a real issue mitigated by tax simplification. A simpler individual income tax system that requires filing a single page has broad public appeal, and there would be no need for an alternative minimum tax.

The Dodd–Frank Wall Street Reform and Consumer Protection Act, Basel III, and other financial regulations imposed in 2009 sought to address systemic financial risks, but instead increased consumer costs and reduced market liquidity. Cost of bank products has increased---for example, availability of free checking accounts plunged, while account balances required for premium services soared. Yet, many real threats were not addressed, including reforming credit rating agencies (i.e., Moody's, S&P, etc.) and government-sponsored mortgage lenders, like Freddie Mac and Fannie Mae. Large banks are more concentrated as they acquire smaller and innovative companies, which find it difficult to remain independent. Fewer new banks are being chartered, as well.

An effective way to reduce bank concentration or too-big-to-fail is to increase competition. Increasing compliance costs, with overlapping regulators and redundancy, disadvantage smaller competitors and reduce global competitiveness. Reorganizing financial regulators into three agencies, namely banking, securities, and insurance, can reduce redundancy and streamline compliance. Some may still be accountable up to three, but not half a dozen that are rarely cooperating in an integrated and efficient manner.

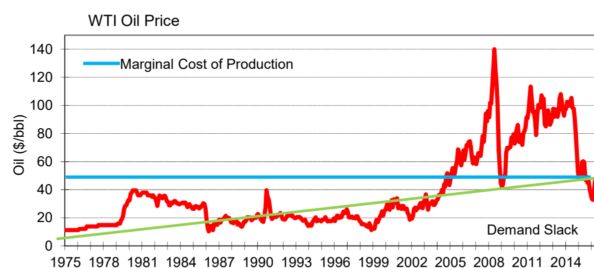
- **Overweight Financials:** Dodd-Frank should be repealed or modified, including regulatory redundancy (i.e., CFPB). Smarter regulation and higher interest rates should bolster earnings growth.

Regulation made trading derivatives and bonds more expensive by limiting market making activities. New capital requirements reduced credit available. Equity trading became more fragmented (ex: try executing 10,000 share block). High compliance and regulatory hurdles have limited competition and innovation from smaller companies. These factors led to increased institutional utilization of ETFs and OTC derivatives on ETFs as an alternative to listed futures and options. Swaps and other OTC derivative volume soared despite their higher cost, illiquidity, and greater counterparty risk. How has securities trading changed? Likelihood of a financial transaction tax has diminished.

Trade treaties seek to normalize otherwise inefficient or onerous taxes, tariffs, restrictions, or other protectionist limitations on exchange of goods and services between specific countries. In a perfect world, there is no need for trade treaties, but every country is prone to some level of protectionism. Thus, America should only negotiate simpler bilateral agreements, which are easier to negotiate and require less compromise. In place of the Trans-Pacific Partnership, separate agreements with Japan and China are preferred. We shouldn't attempt to couple emerging markets with developed nations in multi-lateral agreements. Revisiting NAFTA can separate trade agreements with Mexico and Canada. The U.S. still has no agreement with the European Union, but Canada just signed one.

Comparative advantage provides that companies or nations benefit from leveraging particular differences in capabilities or cost of resources. Each country will seek to increase demand by exporting that which it has a comparative advantage, while importing goods or services it can't produce locally at lower cost or better quality. Countries may protect market share by taxing or limiting competing imports to offset external advantage. Multi-lateral trade agreements are difficult to negotiate and enforce, while subject to greater compromise than bilateral agreements.

We have long believed that conservation, substitution and innovation would drive oil prices lower toward $50/barrel and domestic supply higher. An oil glut and expanding natural gas reserves will persist with new discoveries, leveraging innovation and technology. Higher U.S. fuel economy has slowed global growth in oil demand. Innovations in fuel production exist to enhance miles per barrel of oil with lower emissions. Instead of limiting production or transport of energy resources, we encourage greater energy efficiency with reduced environmental impact. Wouldn't society benefit more by 10-20% increases in efficiency with reduced emissions across 90-100% of energy utilization than driving energy costs higher or limiting production and transportation? Limiting pipeline development has burdened railway transport, which increases spill risk, consumer costs, and emissions versus pipelines.



Domestic Energy policy likely includes adapting production, pipeline, and power plant restrictions to promote prudent development. Increased output of oil and gas can displace foreign dependency, lower energy costs, and improve net trade, all of which boost GDP, expand employment, and strengthen the U.S. dollar. Energy policy should balance distributing efficient power with environmental concerns.

- Favor **Energy Services, Pipelines, Natural Gas**.

Infrastructure Considerations

Candidates promised greater infrastructure spending, including up to $1 trillion over the next decade, but the key question for such a commitment is how to fund more than $100 billion a year when our fiscal deficit is increasingly unsustainable. Infrastructure investment need does coincide with strong demand for private investment opportunities. Instead of increasing the fiscal deficit, it is logical to leverage exceptional low cost financing and support private sector development without burdening taxpayers further. In this way, we see a higher likelihood of a sustained boost to potential growth of targeted infrastructure investment. Government spending can bolster economic growth, but increasing debt borrows from future prosperity and economic multipliers are not accretive to growth, according to much of the academic research.

Fiscal stimulus programs are ineffective and inefficient. For example, the $870 billion American Recovery and Reinvestment Act (ARRA) of 2009 hoped to provide a boost to GDP with shovel-ready jobs for a nation in recession—it failed miserably and added almost another $1 trillion of debt. The economy was already recovering by Q2/2009, well before awarding the first contracts. A southern border wall plus last years' $300 billion highway bill are already queued up for 2017. McKinsey has observed that U.S. federal, state, and local infrastructure spending of 3.2% of GDP has exceeded Japan and the European Union since 2000. That begs the question how much more do we need?

Instead of a taxpayer funded redo of ARRA, the source of financing can dictate the return on investment. In other words, if infrastructure projects must meet a higher standard of yielding a commercially compelling return, held accountable by investors, then America can achieve greater job growth and economic benefit without more federal debt. Construction spending tends to be cyclically transitory with ever lower labor intensity given automation and equipment engineered to minimize labor costs. Investors should expect reduced fiscal deficits with the current Congressional leadership if they remain true to their promoted beliefs.

Many projects may not require government outlay of funds—this idea is not obvious to the consensus yet. Relaxing permitting and administrative hurdles, as well as providing government lending or tax credits can bolster project returns, attracting investors. Pipelines, railways, airports, power plants, fiber networks, commodity exploration, electricity grids, tollways, dams, water treatment, desalinization, and bridges can recover construction costs from benefiting companies or consumers. Tax reform should further bolster investment spending with repatriated foreign earnings (reduced 10-20% tax rate). Congress will be reluctant to increase fiscal deficits. With so many ways to finance infrastructure, a program of initiatives is more likely than a massive infrastructure bill.

The U.S. Government acquired land and property at an astonishing rate, which limited commercial utilization and extracting natural resources, while accumulating significant debt. The U.S. Government now owns half of the Western United States and 28% of all land, including 85% of Nevada, 64% of Utah and Idaho, and 60% of Alaska (State of Alaska retains 28%). Our National Parks are magnificent assets, but comprise just 13% of 609 million acres of U.S. Government holdings. The U.S. Land and Conservation Fund still budgets $900 million/year for acquisition, yet struggles to maintain existing land, buildings, parks, monuments, and forests. Privatization could be another way to fund infrastructure investment and upgrade strategic assets.

Privatizations were popular in the 1990s, particularly among developing economies, but have stalled with governments' reluctance to relinquish control. Yet, the U.S. Government faces many challenges managing its holdings, including underutilization. Agencies argue against disposal, except under dire circumstances, such as the European Sovereign Debt Crisis. Property disposals could reduce debt and operating expense, or provide capital needed to develop new projects. Increased privatization might help satisfy growing investor demand, but few significant infrastructure assets have changed hands recently.

Asset owners have been successful partnering to take advantage of their scale, financing flexibility, and longer time horizon in infrastructure, as with real estate. While investment demand has increased, the number and size of deals was limited driving high valuations. Thus, it seems timely to raise cash by divesting holdings, including ports, airports, buildings, railways, land, and essential services. Easing permitting and regulatory requirements can increase commercial viability of financing many projects.

Private investor accountability improves development projects, including those financed through Public-Private Partnerships (P3). It should be more popular out of fiscal necessity, while reducing taxpayer cost with better aligning private operators to efficiently develop and manage assets. Real property disposals can fund new projects to balance social good with fiscal prudence. Tax incentives can enhance investor returns, thereby increasing price and limiting taxpayers' burden. P3 projects tend to be better managed during development and operational life at lower cost.

BREXIT—Oh Behave!

The British Chancellor of the Exchequer pronounced that BREXIT or Britain voting to leave the European Union would cause "an immediate and profound economic shock" that would lead to a sharp rise in

unemployment and a recession. Policymakers and bureaucrats across the Europe, as well as investment banks, asset managers, and consulting firms were fearful that London would cease to be a financial center if the United Kingdom voted to leave the European Union. Economic conditions are little changed, despite the dire warnings of imminent doom. The U.K. economy even strengthened versus before the BREXIT vote, benefiting from a weaker British pound. This isn't the first time naïve assumptions misled complacent political elites. BREXIT necessitates pursuing multiple trade bilateral agreements simultaneously, beginning with the U.S. and Europe, but we don't expect the economy to devolve into chaos, as so many predict.

On June 24th, we published *British Independence Day*. Our view after the vote was much more constructive than most global economists and strategists on the consequences to British and global economic growth. We thought falling global equities, lower bond yields, stronger yen, and higher gold should reverse upon greater reflection. U.K. economic productivity has declined with burdensome EU regulation and laws. Passporting provides rights for a company registered in the European Economic Area to do business in any other country without needing further authorization, and thus is the most immediate concern to negotiate. This should be resolved given mutual benefit for all.

Britain has decided to take back sovereign control by declaring their independence from EU central planning by reasserting sovereign control over British law, regulation, defense, and immigration. Discarding a 40-year multilateral treaty is not without consequences, but long-term benefits of increased fiscal control, economic productivity, and sovereignty can outweigh the reputed advantages of a common market. Starting from scratch, the potential for improved sovereign control and terms of trade should be constructive for the U.K. A less encumbered City of London may emerge with distinct competitive advantages over other financial centers in Brussels, Frankfurt, or Paris from regulating compensation to transaction taxes considered. Threats to the European Union continue with pivotal upcoming elections in Austria, France, and Germany, as well as an Italian referendum on parliamentary reform.

Focus On Simple Things First

Maintaining an edge adding value has become more difficult as returns compressed and correlation increased, but we expect macroeconomic divergences to increase benefiting top-down, as well as security selection. We must work even harder to uncover new investment opportunities efficiently and consistently at even lower cost. Recurring cognitive and emotional biases intuitively provide exploitable inefficiencies, if we remain true to our discipline. Declining small size, unlisted, and illiquidity premiums in private assets suggests a greater need to embrace novel and inventive strategies and opportunities, while relying more on active management. Layering unfunded derivative strategies such as tactical asset allocation can be compelling, enhancing potential excess return and enhancing active risk diversification.

I was recently asked: What are some of the things you want to get out of an asset management relationship, other than investment performance? This is a question that every investor should ask and every asset manager should consider. After performance or value added, these are a few of the other important things:

1. *Performance consistency*--- hit ratio (monthly frequency of value added) and information ratio (IR = Active return/Tracking error) quantify this. The longer the measurement period, the less likely it is luck.

2. *Good attribution of performance*. Explain why strategies won and lost is important, and it should be intuitively consistent with your stated discipline.

3. *Transparency on costs,* and make sure they aren't unreasonable—bottom third is better.

4. *No surprises, no conflicts, don't embarrass yourself*. Don't do anything that you'd be ashamed to read in the WSJ.

5. *Good or bad, just show up*. Too many managers are afraid to call or meet with clients when experiencing a rough patch of performance.

Asset owners and their managers should focus on objective driven preferences seeking to maximize risk-adjusted return. Many alternative portfolio allocation schemes have distracted us from the prudent goal, swayed by misaligned objectives or incentives. Few industries are as regulated as financial services. Excessive regulation increased trading costs while limiting new entrants and smaller companies that might increase competition. Upstarts tend to merge or fail more quickly these days, but there is an opportunity for those willing to climb the hurdle of increased scrutiny and liability. Finally, fat margins are coming under increasing pressure, driving focus cost reduction.

Wealth management has the highest margins, so has seen the greatest change as financial advisors rotate from mutual funds to managed accounts, seeking to lower cost, increase flexibility, and optimize tax management. Smaller asset owners should discover the breadth of portfolio strategy platforms (i.e., SMA, UMA, TAMP) at 25-50% of the cost of mutual funds, aided by strategic and tactical asset allocation advisors. Asset owners are likely to increase internally directly managed portfolios, seeking to lower cost, enhance value added, and benefit from internal staff.

Concluding Thoughts

Anxiety about slow global growth remains high, but the U.S. economy has avoided certain competitiveness headwinds of other countries. Business owners have adapted well for seven years, driving up profit margins to record highs, but new business formations have plunged by nearly a third. Small business is America's growth engine, but business closures cannot exceed company start-ups for an extended period, as observed today. Continued efficiency gains needed to maintain productivity appear limited. A period of normalizing interest rates and inflation expectations is likely to increase volatility. Much has been disrupted by *Ruthlessness of Unruly Forces,* resulting in many secular and cyclical changes. We should anticipate greater economic dispersion.

Economic consequences of a policy pivot should reverse some of these challenges to bolster small business creation and potential growth. Congress now has the ability to advance pro-growth economic policies resulting in stronger potential growth and higher margins, while bolstering exports and investment. Effects of shifting fiscal, tax, regulatory, trade, energy, immigration, security, and monetary policy should become visible in 2017. After seven lean years of a disappointing economic recovery, America's potential growth and prosperity can be restored with measured changes in government policies.

We believe America, Inc. will be re-engineered for optimal economic performance, focused on policies that improve global competitiveness. Concern that trade and the fiscal deficit will decline is inconsistent with that objective, but key appointments will be closely followed. Threat of new import tariffs or renegotiating trade agreements may heighten anxiety among our trade partners, but the man behind the *Art of the Deal* should accelerate onshoring and improve our trade balance, not undermine it.

We have identified significant investment conclusions resulting from the *Ruthlessness of Unruly Forces*. The pivot in U.S. policy from the shifting balance of power should yield better economic growth and greater tax revenue, even with lower tax rates and tax code simplification. Increasing potential growth, global competitiveness, and tax reform should promote onshoring, increase investment, and improve our trade balance. Freeing up gridlock provides an opportunity for simpler and purposeful legislation without politically expedient earmarks and riders that cost taxpayers.

Our global tactical models, supported by compelling equity valuation and low interest rates with positive economic growth and low inflation, favor a global equity overweight versus bond underweight. Return forecasts for U.S. equities with a small-cap tilt improved and are the most attractive global market, followed by Australia, Continental Europe, and Canada. U.S. and U.K. bonds return forecasts remain negative. We expect the U.S. dollar will strengthen versus European currencies.

Although consensus expects equity market volatility to increase, it hasn't. Instead, greater volatility-of-volatility in equities is consistent with policy uncertainty, greater economic dispersion, and an inflection point in interest rates. We expect higher bond and currency volatility, exacerbated by reduced bond market liquidity and increasing restraints on market makers. Investors need to extend their time horizon and simplify their strategic asset allocation. Correlations are evolving more quickly with increased economic dispersion and an inflection point in interest rates. Publication of *Alternative Reality* on StrategicCAPM.com may be helpful in considering the outlook and risk impact of alternative investments.

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