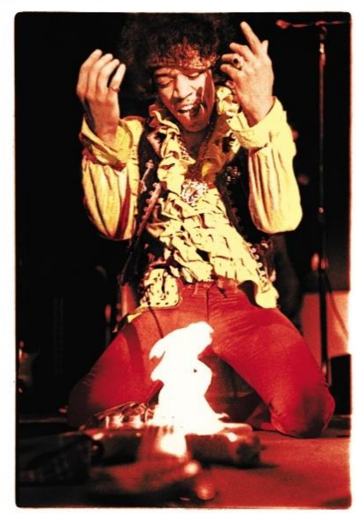
## | 2017 FIRST QUARTER COMMENTARY

### LET ME STAND NEXT TO YOUR FIRE

Fire. Shamans dance around it, dancers revel in it, and revelers are hypnotized by it. Some of us it draws near and seems to carry a gravitational field that can only be explained with a combination of science and voodoo. Originally characterized as one of the four elements by the Greeks, our infatuation with fire has been documented by artists, poets and musicians who have tested the boundaries of language in an attempt to uncover its mysterious beauty.

Here's where Jimi Hendrix comes into play. Rather than fall into the old idiomatic transition with the cliché "play with fire and you're gonna get burned," I opted for the more obtuse "this day in history" approach:

Almost exactly 50 years ago, on March 31st 1967, Jimi Hendrix burned his hands while lighting his guitar on fire for the first time.



*"You don't care for me*
*I don'-a care about that*
*Gotta new fool, ha!*
*I like it like that*

*I have only one burning desire*
*Let me stand next to your fire"*

"Fire" – Jimi Hendrix

*Putting secular context around the cyclical environment is key in the investment-decision making process.*

Equity markets were burning bright (again) last quarter. The bonfire has continued well into the evening, and the day seems to have more than 24 hours. It can be tempting to inch closer (and indeed there may be some opportunities) but we enter the second quarter with cautious optimism in the year ahead. Here is a brief secular picture of where we stand today to help put our cyclical outlook into context:

- The US bull market in equities is 87 months old and still looks reasonably strong
- Global interest rates remain near 35-year lows
- Inflation measures are showing signs of green shoots (remember that phrase?), BUT…
- …The markets have become much more expensive as valuation multiples of all kinds have expanded

This commentary will touch on two themes: First, we will try to keep a finger on the political pulse; second, we observe global reflation in a cyclical expansion. I'm going to keep this commentary relatively high level because we are making more changes than usual over the coming weeks. Next quarter's commentary will likely discuss many of these changes, while of course our clients will hear about them as they occur.

## KEEPING A FINGER ON THE POLITICAL PULSE

The Trump rally that cajoled markets went on to produce returns of over 11% for US equities from post-election until the end of March. Although markets showed their impatience, the move may not have been a flash in the pan—markets also showed optimism and a risk-seeking mentality that has continued until today. And while politics in the US still make for good day-to-day news, the future is a little clearer today than it was six months ago.

Europe's outlook is not quite so certain—although perhaps a little better in April than it was at the beginning of March. Concerns over Italy's rejection to centralize power fizzled quickly here in the US, although the Five Star movement (the anti-European integration political party) continues to gather steam with backing from over 30% of Italians according to one of the latest opinion polls. According to Alessandro Di Battista, one of the leaders of the movement, they "target a 40% win, which would allow [us] to obtain the mandate to form a new government." A new government wouldn't necessarily mean Italy would leave the EU but perceived EU risk would certainly increase. What do the Italian people want and what will a new government do to deliver the people what they want? Keep in mind, Italian banks have perhaps the worst balance sheets in the Euro-zone and many say a "leave" would be too disastrous—that it cannot be allowed to happen.

On a somewhat-rosier note, the re-election of Rutte and the pro-EU party in the Netherlands on March 15th showed us that populism was not the only game in town. It appeared the polls this time had *overestimated* the degree to which a populist party had taken hold. Of course, France and Germany have elections this year and we will keep a close eye on those, but given some EU-breakup risks have waned and valuations in Europe are reasonably cheap relative to historical averages, we believed it prudent to take risk and added a bespoke position in European equities the day after the Dutch election's pro-EU result.

**Drain the Swamp?**

*In the United States, the pro-business administration has been more of a boon to markets than populism has been a burden.*

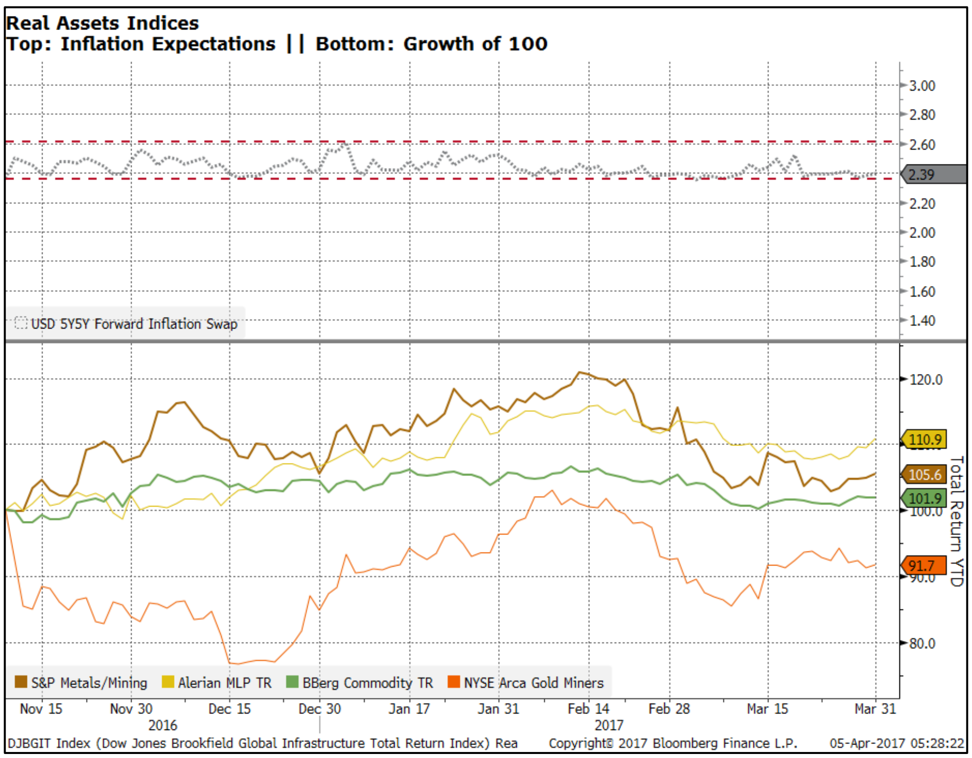
The United States is experiencing a bit of what the French call "feux folles" (literally "crazy fire" – a brief flicker of flame that occurs when gas is released from the dregs of a swamp) as the executive branch struggles to push its agenda through the political machine. In theory, a Republican supermajority should reduce political uncertainty. In practice, that has not quite (yet) been the case. Certainly the administration has come out swinging but so far the first couple attempts have been whiffs. Tax reform is likely next on the list and has a direct, measurable impact on corporate America—in particular, a move to simplify tax code could be seen as a major positive. The night is still young…

So what does it all mean? As I mentioned in last quarter's commentary, the market has not seemed to mind populism here in the US. At the least, the pro-business administration has been more of a boon to markets than populism has been a burden. In Europe, however, populism has not been considered pro-business and has been treated very differently by the markets. We are monitoring various measures such as changes in government bond yields across Europe and relationships between currencies and rates in order to determine how we believe the market is interpreting news. That, in turn, helps us to make sure we are assessing the potential upside/downside to our positions and whether or not we are taking what we believe is asymmetric risk, for example, in equities.

## GLOBAL REFLATION IN A CYCLICAL EXPANSION

*Inflation expectations have consolidated since the US election.*

Inflation expectations (as measured by the 5y5y forward swap) have generally been on the decline since the end of the great recession. The US, UK and Europe have felt the pains of global disinflation almost equally from their highs in 2009 through June of last year. Each region's inflation expectations jumped last year, beginning with the UK/Brexit in June and following through the US election in November. Since then, however, inflation expectations have been range-bound and many commodity-sensitive markets began to fall once commodities established near-term highs in mid-February. The chart below looks at US inflation expectations (top half) and the total return of some inflation-sensitive indices (bottom half) since the US Presidential election.




*Source: Bloomberg, as of 3/31/2017*

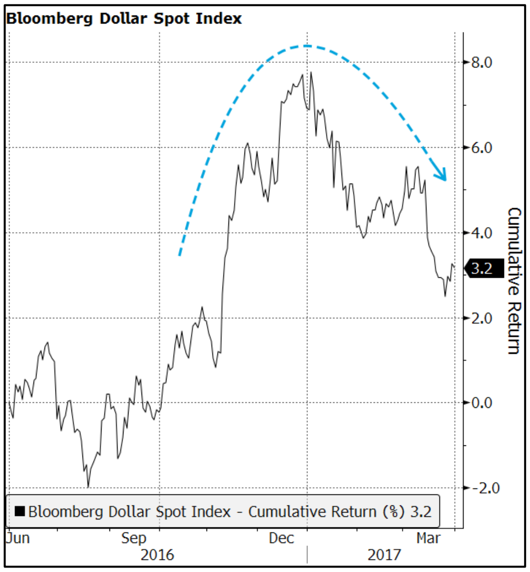
We believe this pause in inflation-sensitive assets is healthy and we are optimistic that there will be more follow-through in the cyclical reflation trade. Contributing to that thesis is the following:

- **Risk appetite is generally still increasing.** Last quarter, emerging markets equities were up almost 11.5% in USD while developed equities were up about 6.4% in USD. Emerging markets equities tend to do well during high growth, high inflation periods and that rotation is still somewhat new.
- **Dovish speak from voting members of the Federal Reserve.** Bankers will likely err on the side of inflation rather than deflation. Even during a rising rate environment, inflation shock risk is probably to the upside rather than to the downside.

- Protectionism will add fuel to the inflationary fire. Politics aside, any sort of protectionist measures will likely slow labor supply and cause wage inflation in lower-skill, lower-wage jobs—generally those workers spend their entire paycheck.

*The Bloomberg Dollar Spot Index fell 3.5% during the quarter, retracing about half of last quarter's gains.*

Somewhat related to global reflation is the US Dollar. There was significant rotation out of the Dollar and into other developed and emerging currencies. For example, (against the USD) the Japanese Yen was up 7.5%, the Mexican Peso was up 8.5%, the Euro was up 2.5%, the Taiwanese Dollar was up 6.9%... the obvious laggard here is the US Dollar and we've included a chart of the Bloomberg Dollar Spot Index in order to show the rotation away from the greenback and into other currencies.




*Source: Bloomberg, as of 3/31/2017*

## INVESTING TODAY

It is one thing to write about the potential in a cyclical reflationary expansion and another thing to invest in it. In light of the secular themes listed at the beginning of this quarter's commentary, we are not advocating significant risk today. In fact, the prudent investor's paradox that we discussed last year is just as important today as it was six months ago: Although chances of upside growth are higher, the magnitude of downside risk is large even if the chance that it occurs is not. Investing in a fat tail environment is tricky and requires patience along with the right kinds of alternative strategies.

Our objective in the liquid alternative strategies allocation is to earn a mid-single digit return without having to suffer through deep, painful drawdowns. That many of those alternative strategies zig when the market zags allows us to take risk in more traditional investments like stocks or bonds while still having a significant hedge in the portfolio if the macro environment suddenly turns sour.

We remain underweight equities and traditional fixed income, we are slightly bullish on real assets and we are overweight alternative strategies. Within alternative strategies we are overweight event-driven, overweight macro, neutral on long/short equity and underweight relative value.

Here's to playing with fire without getting burned (I couldn't resist),

Jonathan Belanger, CFA
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