GLOBAL UPDATE

May 2017
Reflection and Renewal

First, I'd like to thank you, my friend and/or client, for your relationship through the years. I am truly grateful for having been blessed to work with so many talented and interesting people. Your continued trust and support inspire me to come to work every day and do my absolute best to make what I believe to be the most thoughtful and informed decisions on your behalf.

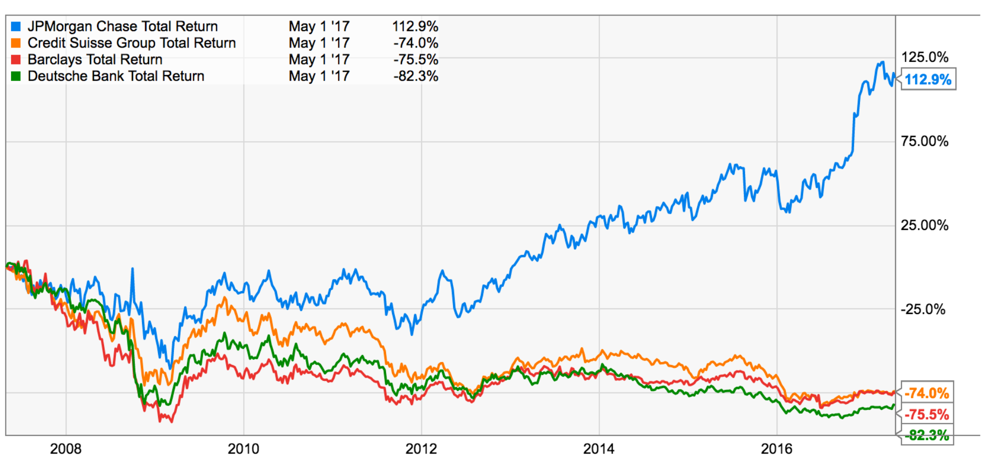
July will mark five years since our team chose to affiliate with Commonwealth Financial Network. Commonwealth has been a great partner to our practice. They have a tremendous depth of resources, from research to financial planning to technology, with an amazingly friendly and knowledgeable staff. Their culture is second to none in the financial industry.

As my partners and I reflect on our business, our main focus for the year ahead is two fold. Our first goal is to enrich the communications and service we deliver to you as our client. From planning information and our regular service calls, to brief and important market updates. We want to deliver not only more information, but more useful information to you on a timely basis. We will become more active on our website and we will use our social media more frequently, so please follow us on Facebook and Twitter. We will direct you to our website more frequently when it becomes interactive. Our second goal is to relaunch our brand. We've created our own unique culture over five years. We've had two advisors join us since our launch, one as recently as February. We've found some very common characteristics among us that we feel are worth letting you know about. Of those characteristics, one that we are acting on is our joint appreciation and support for "sustainability", particularly as it relates to the environment. On a personal level, my family has taken on the project of beginning a "permaculture" orchard over the last year. Because of this environmental appreciation, we are implementing two practices of note. First, we will be launching a portfolio option that features environmentally sustainable companies and strategies across a variety of industries. Second, we've aligned our corporate logo gear and other marketing items with our principles. As an example, one of the companies we respect and admire for their efforts in sustainability, fair wage practices and recycling is Patagonia. If you haven't visited their website lately, their efforts in many areas are inspiring, and they've created short educational films that my children and I enjoy watching. Our 44 North Financial Partners t-shirts are now sourced from Patagonia.

Typically, twice a year, I head off to Commonwealth conferences designed to enrich our knowledge and share ideas with peers. As I write this, I am on my way to San Francisco for the week for such a meeting. I'll also take the opportunity to meet with a money manager who we use in our Advisory portfolios, as well as a client who happens to be in town for a business meeting. Not having spent much time in San Francisco, I'm planning to use the off hours to explore the city, taking a tour of Alcatraz and a walking tour of the Haight Ashbury district. I'm looking forward to the week.

Markets & Economy:

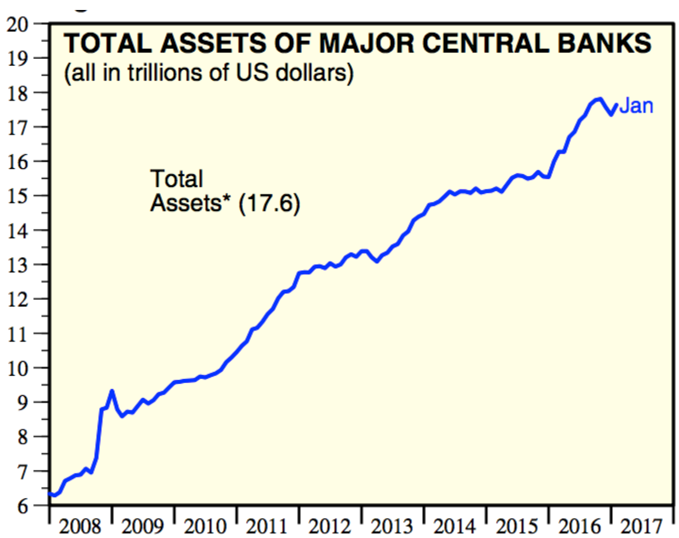
So far this year, the U.S. equity market has shrugged off gridlock in Washington, and as of this writing, global markets just dodged a potential bullet in the French election. It seems that the global populist movement that supported the Brexit vote, and led to the election of our President Trump, has stalled in Europe. In the past two elections, populist candidates Geert Wilders of the Netherlands and Marine LePen of France were defeated by either "left" or "centrist" candidates. While you may not immediately recognize the significance of these elections on the markets, when you look at the price performance of European banks, it begins to make complete sense. The chart below shows the decade, from May 1, 2007 - May 1, 2017 (source: YCharts), of performance of JP Morgan vs. three of the largest European financials, Credit Suisse, Barclays and Deutsche Bank.



Financial stability via a strong banking system has obviously not yet returned to Europe. Their banks retain bad debts, never shed from their balance sheets since "the Great Recession". What has saved them, however, is the continued flow of printed money from global central banks, specifically the European Central Bank (ECB). As the U.S. has wound down our printing press, Europe and Japan have accelerated theirs, more than offsetting our reduction.

The chart to the right (source: Bloomberg) shows the printing program in Europe. **EMERGENCY** money printing globally remains in full effect as can be seen by the chart below (presented by Yardeni Research, March 3, 2017), illustrating total assets of central banks around the world.

The main problem with all of the debt creation and money printing is that it decreases future global growth unless bankers can keep rates at or near zero percent. As debt service payments increase in countries around the world, a higher proportion of their tax revenues are required to service that debt, likely leading to increased taxes globally. This robs future growth for immediate gratification.

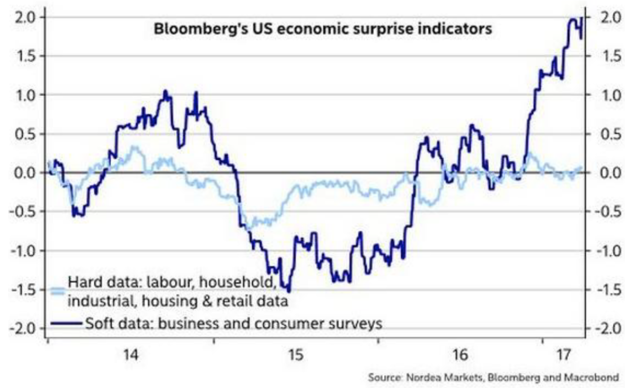


U.S. Economy:

Reuters reported on April 28th that U.S. Gross Domestic Product expanded at a rate of 0.7% for the first quarter of 2017, the slowest rate since first quarter of 2014. Arguments I've heard recently revolve around the acceleration of growth which is expected to result from 1) a reduction in U.S. tax rates for both individuals but primarily in corporations; and 2) a reduction in regulations in both the financial and healthcare/ biotech industries (FDA); and 3) an increase in infrastructure spending.

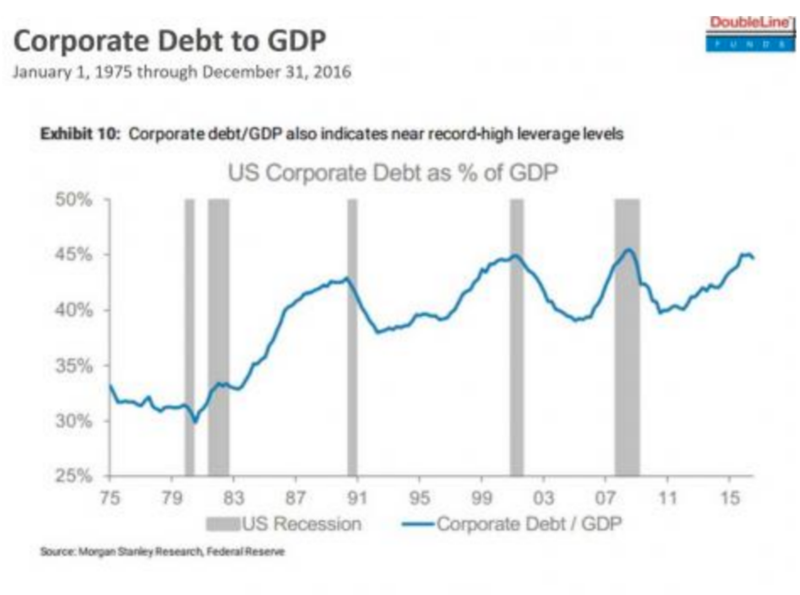
Expectations for Q2 growth are significantly higher, and in my estimates, will likely lead to disappointment. While it has been proclaimed that the U.S. has obtained "full employment", the participation rate remains stubbornly low. Consumer spending growth has been lackluster, and we're seeing signs of stress in certain markets such as auto and student loans. According to Moody's (released in March), "the average loan period for a new car has risen from 62 months in 2016 to 68 months now. For subprime borrowers, the average loan term is now 72 months." This is sometimes referred to as "extend and pretend" lending; it's what happens at the tail end of a credit boom.

In the chart to the right, which contrasts hard data (actual reported data) vs. soft data (obtained from surveys), the disconnect becomes apparent between expectations and actual growth. Markets have likely built in these expectations, and we believe they will ultimately adjust downward to reflect reality. This may not happen immediately however, because sentiment can drive markets to extremes. We believe this process is unfolding currently, and will likely lead to a final “blow off top” where markets reach new highs later this year, which are ultimately not sustainable.



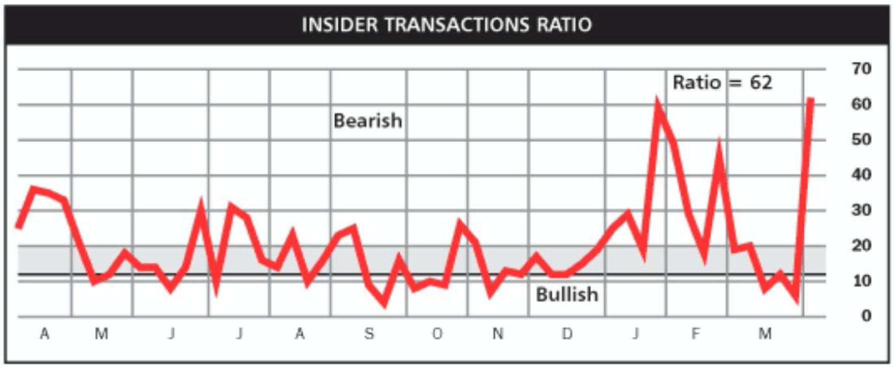
Other indicators regarding valuation are concerning as well, such as the “price to sales” ratio for the S&P 500 (left), which can’t be manipulated like corporate bottom lines because it simply reflects overall sales. Current values are well into bubble territory, and have only been surpassed one time since 1990, and that was during the internet bubble.

In addition to high valuations, corporations have “levered-up” their balance sheets with the cheap and abundant credit that has been created by central banks. The chart below shows that the current level of corporate debt to GDP is as high as it was at the 2000 and the 2007 peaks, leaving little room for further expansion.



It seems that corporate insiders “get the joke” (see chart on next page) as the ratio of insider sales to purchases has spiked of late, a possible sign that those running the companies believe they’ve done all of the engineering possible, and don’t see the sales figures meeting future growth expectations.

If you’ve been a reader of my past



Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish.
The total top 20 sales and buys are 332,584,800 and 5,333,948 respectively; Source: Thomson Reuters

newsletters, you're likely aware of my long-standing market valuation concerns. There is one way I can conceive of, however, in which markets remain afloat over the longer term. That has to do with a continuation of money printing programs from the global central banks.

I believed Ben Bernanke and the U.S. Federal Reserve Bank ("the Fed") when they promised to stop money printing after Quantitative Easing (Q.E.) 1, then Q.E. 2 and finally Q.E. 3, which took us from 2009 - 2015. Their growth targets were never met, and they used this as justification to continue their money printing programs. Now, while the U.S. economy is still trending substantially below par for this phase of a recovery, the Fed is slowly attempting to hike rates, while the European Central Bank and Japan have picked up the printing pace. The net effect, as you saw from the chart on page 3, is that there has been a continual increase in central bank assets, which has flooded the markets with liquidity. Ultimately, central banks will have to decide whether to continue this extraordinary, emergency policy, or whether the risks created by printing too much money and borrowing growth from the future is less desirable. They've already gone well beyond what I viewed as a rational stopping point, and the Japanese government continues to print in light of the fact that their debt to GDP ratio is over 300%! (ours for comparison is roughly 100%, in that our economy is approximately $19.5 trillion, and our debt is roughly $20 trillion). Mathematically, it is virtually impossible for Japan to ever repay its debt, and even stopping printing has become highly unlikely. This means that the most likely outcome is continued printing and devaluation of the Yen, which should create inflation for the Japanese consumer. As the Yen devalues, and Japan's exports become cheaper than their competitors (U.S., Europe, etc.), it puts pressure on other economies to print and devalue their currencies (a phenomenon I've written about in prior newsletters). In a currency war environment, with devaluing paper currencies, stock markets tend to actually do well because hard assets held by businesses appreciate to offset the loss of their respective currencies. Stock markets have also been helped by the fact that central banks themselves have been buyers of stocks. The Swiss National Bank recently released it's asset holdings, and they've been accumulating billions of dollars in equities, and printing money to do it. Likewise, Japan has been a major buyer of Japanese index funds as well as other stocks. I can't say we saw that coming five years ago - can you imagine being able to print money out of thin air at or near zero interest rates and using it to buy stocks?! Only a shock to interest rates would derail that strategy, but if that were to occur, the central bank could print money to buy even more bonds to suppress rates (Japan is currently doing this, and their policy is to keep rates at zero on their 10 year bonds).

In this current environment, it is clear that the group of unelected and omnipotent central bankers rule the day. I am shocked that people, by and large, have not yet caught on, and still perceive that their currencies are safe and stable. I do believe that at some point, the hard and fast laws economics win out, and the bankers get the inflation they so desperately desire - likely a bit more. For this reason, where we take risk in our portfolios, we have begun to focus on “hard assets” as a theme, as these assets typically hold up well in an inflationary environment.

As always, we welcome your questions and comments. We hope you enjoy your summer and that you and your families share wonderful experiences together and find time to pursue activities that are most fulfilling to you.

Our warmest wishes from Maine,

Brian Prichard & Your Team at 44 North Financial Partners