2017 Investment Letter

January 2017

WELCOME to our annual January Newsletter. We generally try to publish it as close to January 1st as possible because the New Year is always a good opportunity for reflection. This year however, we decided to take a little more time to collect our thoughts. After all, no transfer of political power in memory has felt more like the end of one era and the beginning of another.

Although there are strong feelings everywhere regarding the new administration, as financial advisors our job is to be as objective as possible. This objectivity should be devoid of emotion because, as we hear all the time, our emotions tend to lead us astray when it comes to our money. Today, the emotion that seemingly has gotten a hold of everyone is *uncertainty*. Despite the fact that the economy actually appears to be on solid footing at the moment, everyone is waiting to see what happens next.

The way we at Longwave grapple deal with this changing landscape is by going back to investment philosophy for guidance. It's the lens through which we see the world and our compass when things seem "unprecedented". First, we try to maintain a long-term perspective: over time market returns tend do to be driven by fundamentals rather than anecdotes and emotion. Second, we believe in free markets and that capitalism works over the long haul. We feel confident that these foundational beliefs will help us and our clients drown out the constant media noise and make sound financial and investment decisions.

Below, we share our thoughts about the incoming administration, what this economic cycle may have in store for us and continue to focus on things in our financial lives that we can actually control.

THE FIRST 100 DAYS

President Trump has set for himself an ambitious agenda, including much that he would like to accomplish in his first 100 days. Having moved into the White House, we now recognize that Trump's campaign rhetoric was sincere. With an assumed mandate for change, he appears not to be wasting any time going down his wish list.

Nathan Munits,
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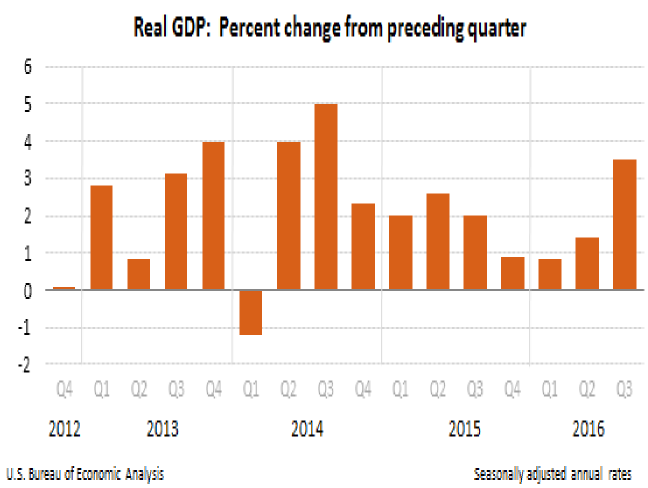
Donald Trump is taking over one of the stronger US economies any president has inherited in recent history. The economy has grown virtually non-stop for eight years, ranking this expansion the fourth-longest since 1949 (when quarterly data became available). This is in sharp contrast to the free-falling economy Barack Obama inherited in 2009, when the US was losing almost 800,000 jobs a month.

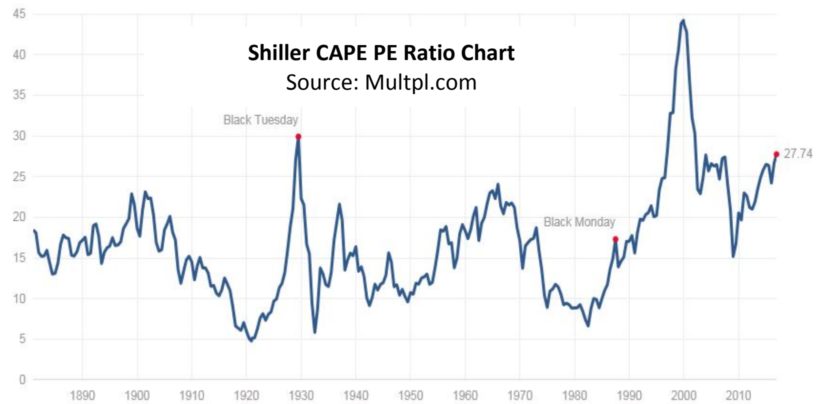
Today, unemployment stands at a nine-year low, the stock market continues to break records, wages are accelerating, and home sales hit their highest rate since 2007.

While these are undoubtedly indicators of economic strength, the Obama recovery was also the slowest on record, growing at a rate of around 2.1% per year. One reason for this could have been the hangover from the financial crisis. Other possible reasons include cautious business spending, a low interest rate environment and changing labor demographics.



Furthermore while headline unemployment is 4.6% – close to the Fed's definition of "full employment", under-employment is much higher. Indeed, Trump zeroed in on this issue many times during his campaign, suggesting that the economy is much weaker than the government is telling us. In truth, half the drop in labor participation in recent years is attributable to Baby Boomers leaving the workforce. Some of the underemployment can also be due to a sluggish energy sector. (Trump believes that deregulating the coal, gas and oil industries could help in this regard.)

While we don't yet know if unemployment can go lower, we also don't know whether the stock market can continue to go higher. On one hand, the tepid rate of recovery so far suggests continued room for expansion. On the other hand, US stocks may already be quite expensive. According to the Shiller CAPE Ratio, a popular barometer of market value, stocks have been more expensive only two other times - December 1999 and October 1929.



While this by no means suggests that we are in a bubble or that a market correction is imminent, it does suggest stock market returns in the near future are more likely to be subdued.

Regardless of where we actually are in this market cycle, Trump thinks he can increase growth substantially. If Trump is right and significant weakness remains in the labor market, a big government spending package could seriously boost growth. In that context, the significant tax cuts and infrastructure spending Trump pledged on the campaign trail could make a lot of sense.

If however, instead the labor market is strong, as the Federal Reserve and most mainstream economists contend, more subtle solutions would be required. Targeted jobs training, a simpler tax code, less burdensome regulations and of course a better health care system could all increase productivity and generate inflation-free growth.

Therefore, while some would suggest that today's economy requires a scalpel, the pessimistic view would prescribe a sledgehammer. As the White House is clearly in the latter camp, they are wasting no time pushing forward a high impact policy agenda: deregulation, stimulus, protectionism, and tax cuts.

As we at Longwave consider this economic plan, we believe some of Trump's proposals could have a positive effect in the short term. Over the long term however, some of these become problematic. Massive fiscal outlays risk boosting demand for everything from workers to raw materials, spurring inflation and even fueling bubbles. As a result, such policies could result in higher debt, higher interest rates and thus higher borrowing costs, dampening the effects of any stimulus.

Stimulus can be problematic in other ways such as when certain industries are favored over others. We believe that business is much better at allocating capital than government. Indeed, the on-going shift of manufacturing overseas is a natural and inevitable consequence of the United States moving to a more knowledge based economy. As The Economist magazine succinctly put it recently:

"If a company makes an investment decision on the back of a tax break or a threatening presidential tweet, then it is probably not making the most efficient use of its capital. It may seem like good news in the short term for the workers who keep their jobs. But it is not good in the long run. The companies they work for will be less competitive in international markets; and, as consumers, workers will either pay higher prices or buy inferior goods".

Trade and cooperation are good for the world so naturally we are also uncomfortable with the White House's protectionist rhetoric, already beginning to erode trust with our key trading partners. The risk today is a period of "deglobalization," which could further slow growth in trade, hinder capital flows and erode the "multinational business model" adopted by many corporations. Protectionist trade policies have consistently been self-defeating in the past and we feel this time will be no different.

Finally, restrictive immigration policy threatens a major pillar of American success and exceptionalism. An illustrative statistic is that roughly 50% of the country's corporate "unicorns" — private companies with $1 billion-plus valuations — have at least one immigrant founder at the helm, according to a report last March from the National Foundation For American Policy.

Likewise, Longwave Financial can also count one founder who is an immigrant refugee from an erstwhile hostile nation.

2016 FINANCIAL YEAR IN REVIEW

We are all hard-wired with a survival instinct which urges us to "do something" when we perceive danger. As investors however, we need to resist this urge.

"Wall Street has Worst Start to Year Ever" was the headline from Reuters in January 2016. By February 11th, the market had fallen by an impressive 10% from January 1st. Overseas markets saw declines of almost 15% while smaller companies saw the biggest selloff, shedding almost 20% of their value (the definition of a bear market).

Anyone actively following the news could certainly have been spooked by fears of weakening global growth, volatility in China, and an energy sector in crisis. However, by mid-year account values had made up the losses. Later in the year, the election was yet another example that prognostication is extraordinarily tricky.

Ultimately, the S&P had realized a 12% gain for 2016, propelled by a broadly improving economy and perhaps optimism for a business-friendly Trump presidency.

But, while 2016 was above average for the stock market, bonds had their worst month in 25 years in the aftermath of Trump's election win. The corollary to this was a huge jump in short term interest rates from 1.37% to around 2.6%. Certainly the bond market is so far predicting a stronger dollar and possible inflation for the coming year.

Overseas, there was a big turn-around in emerging markets. After several years of underperformance, emerging markets in 2016 returned 11.6% on the back of recoveries in India and Brazil. Still, emerging markets would have done much better last year if they had not given back 4.1% in the 4th quarter. This decline seemed to have been a direct result of Trump's election win.

On the other hand Europe and other non-US developed markets continued to struggle. Their 1.5% annualized return indicates continued weakness and instability, especially going into 2017 when populism should continue to disrupt traditional political dynamics.

In other areas of the investment universe, real estate was subdued on worries that higher borrowing costs will be a drag on profits, oil rebounded but still trades at half of its 2014 high, and gold had an up and down year. Interestingly, we often see gold rally on political uncertainty and inflationary risk but we did not see that in Q4 2016.

Here's a look at the benchmark returns for three possible globally allocated portfolios in 2016:

Stocks/Bond Mix	60/40	80/20	100/0
Return	6.27%	7.21%	8.49%

LOOKING AHEAD

Today, we would rarely take a car ride without GPS. This technology that we mostly take for granted, tells us where we are on our journey and how far we are from our destination. Wouldn't it be great if we had GPS for the economy to tell us where we stand? Unfortunately, economics is imprecise so we need a different yard stick.

As mentioned previously, one of our foundational principals is that the economy and markets go in cycles. As illustrated in the opposite chart, these cycles of recession and recovery tend to play out over 8-10 year periods. By this form of GPS, we may be in the middle or latter part of the present economic cycle.

This is not to say that we will necessarily see a significant market correction or a recession this year. Although market cycles are inevitable, given the likelihood of government stimulus, the next economic contraction may be put on hold for a little while longer.

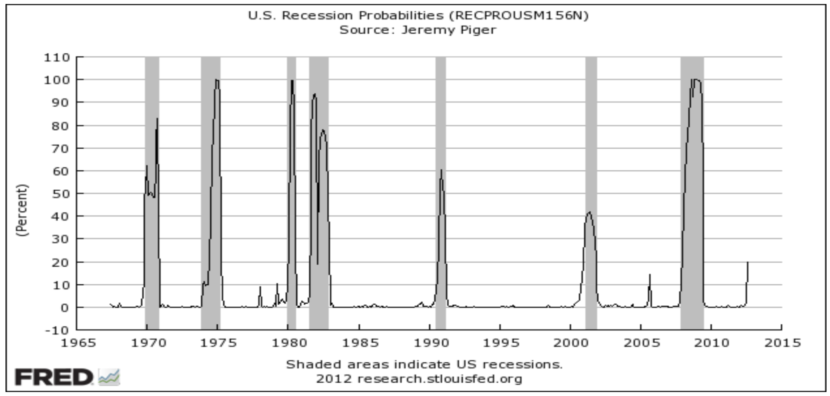
As always, we believe that most investors who are in it for the long haul should not be thinking about drastic portfolio changes. Apart from the virtual impossibility of getting in and out at the right time, market gains and losses tend to happen quickly so missed gains can rarely be made up later on. On the other hand, investors with a short-term savings need such as an upcoming home purchase should consider a conservative approach.

With that in mind, it's still important to know what kind of investor you are. If large swings cause you anxiety and you are feeling especially nervous, consider smaller, incremental shifts to your portfolio. In other words, if you are driving through a storm, you don't turn around and go back home, but perhaps move over to the right lane and drive a bit slower. Of course becoming more conservative means adding bonds and selling stocks which itself is not a risk-free solution. For that reason, if you are feeling the urge to "do something" we invite you to schedule an appointment with us to discuss your options.

THE OPTIMISTS VIEW

What a year it has been. Across the western world populist, inward looking political parties have come into the mainstream. As one writer put it: the politics of left vs. right is being replaced by the politics of open vs. closed. Voters have spoken and in the year ahead citizens will get to see their votes turned into policy.

Despite the populist wave that came over the western world last year, our long-term optimism is not diminished. As Martin Luther King, Jr. said "The arc of history is long, but it bends towards justice". One of the books we read last year was *Progress: Ten Reasons to Look Forward to the Future* by Johan Norberg. Among the encouraging statistics in the book: global poverty has fallen by half over the past 20 years (in a poll, only 5% of Americans knew this to be the case). And the world is inexorably getting more tolerant: "In 1987 only 48% of Americans approved of interracial dating; in 2012 that figure was 86% (and 95% of 18- to 29-year-olds)."



Finally, we like to use this space to reflect on some of amazing human accomplishments of the past year:

- Colombia struck a peace deal to end its 50-year-old fight against the Marxist guerilla group, the FARC
- The Paris Climate Accord was signed by 194 countries
- Space Waves were observed for the first time, greatly advancing our understanding of the universe
- Virtual reality went mainstream
- Cubs Win! Cleveland Wins! In the same year!
- Pope Francis and Patriarch Kirill met in Cuba, the first time the heads of the Roman Catholic and Russian Orthodox churches sat down together in nearly 1,000 years
- British astronaut Tim Peake became the first person to complete a marathon in space, finishing in three hours, 35 minutes

Finally, although we are optimists, we are not blind to the challenges that face mankind. While 2016 went down as the hottest year on record, we remain confident that the human mind is up to the challenges of the future. As for our nation, while today many are disillusioned, we are also seemingly experiencing a civic renaissance with more activism in our communities and greater involvement in the causes people care about. Regardless of your political affiliation, the fact that people care enough about this country to protest and have the freedom to voice their opinions publicly is surely reason for optimism.

Thank you for allowing us to share our thoughts with you. If you have any feedback for us, don't hesitate to write us at info@longwavefinancial.com. Have a great 2017.