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Our 2016 Review and 2017 Outlook

As 2016 comes to an end, we would like to highlight BigSur's performance, which was successfully driven by the views our Investment Committee set forth in our outlook from the beginning of the year. Looking ahead into 2017, we see another positive year for risk-assets and are not recommending any major strategic shift in the asset allocation versus our 2016 recommendations. While we believe investors will benefit from being invested, we are predicting sharper and more frequent market movements in both directions.

Investors continue to work through the implications of global reflation; policy implications of the watershed election results worldwide in 2016; the divergent growth paths of developed and emerging markets; the evolution of China's economic engine; and potentially tighter financial conditions.

As our industry develops, we are excited that we can benchmark ourselves against our peers. The UBS and Campden Research Report[1] of 242 global family offices recently published at the end of October 2016 shows a year-to-date performance of 3.1%. Our customized client portfolios (each of which has a different risk profile and Investment Policy Statement) had an average year-to-date performance of 5.9%[2] for clients with at least $20 million in assets. The reason we selected this client profile was because of the broader allocation to alternative investments, more comparable with the other firms from the report. Our November year-to-date return was 6.3%.

The principal contributors to BigSur's outperformance versus the average global family office's performance were:

1. Asset Allocation: Our primary focus has been on the United States. Each of our clients has had at least 80% of their financial assets in U.S. concentrated investments since 2015 (most have 90%+ in U.S. situs assets). Clients capitalized "big league" on the Trump rally given their U.S.-centric portfolios, which we believe will continue to outperform under Trump's protectionist agenda that is expected to affect global trade policies. Domestic companies will also benefit most directly from corporate tax cuts, repatriation of offshore assets, and increased infrastructure spending.

2. Market Timing: Clients that were tactically positioned and ready to trade throughout volatile periods were most successful, as they had the ability to

The Thinking Man's Approach

December 2016 | Series #46
Ignacio Pakciarz | CEO
Salvador Juncadella | Research Analyst
Rosa Rincon | Portfolio Analyst

Our structural view for 2017 remains positive. The positive fundamental drivers we identified at the start of the year remain intact. However, in the shorter term, there has been huge reflation of risk assets, and the strength and speed of this run up in asset prices will most probably not continue.

The market will start focusing on the Fed's future rate hikes and Trump's agenda will have delays in both negotiations and implementation. This might shift "overly bullish" market sentiment. We recommend our clients to protect against US Bond Duration Risk as well as hedge some of the Equity Risk in the short-term.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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navigate through and prepare for the three major events of the year: 1. January selloff; 2. Brexit; 3. The Trump Election.

In December 2015, we wrote, "2016 is a year to use volatility to our advantage by doing "yield enhancement" strategies and hedging portfolios. Investors need to leave an above average cash level for tactical trading and be ready to execute a planned trade when the circumstance arises." With cash on hand, we were able to swiftly buy into the market during strong pull-backs when VIX was overshot. In moments of irrational exuberance where equity valuations seemed unsustainably high in the short-term, we would buy forward-looking protection to hedge portfolios at minimal cost.

3. Intrinsic Value Assets: In the third bucket of asset allocation, generally referred to as Alternatives (to differentiate from the Traditional asset classes of cash, bonds and stocks), **our focus at BigSur has been on income-producing strategies.** We have recommended a 20-25% allocation to private investments – above the 14% average allocation shown in the UBS and Campden Research survey of global family offices. The survey shows that outperformance amongst global family offices is correlated with a higher allocation to private equity and private debt investments. Our portfolio allocations and outperformances are consistent with this finding.

Our allocation to alternatives when compared to other global family offices shows another significant difference: **we have typically shunned away from hedge funds.** BigSur has consistently been bearish on hedge funds in our 9 years of existence, as we do not feel managers can generate enough alpha in the long-term to compensate for their exceptionally high fees (2/20 or 2% management fee plus a 20% performance fee). Hedge funds have consistently underperformed during the entire post crisis bull market, as well as year-to-date. For the January-to-October period, hedge funds were up 2.85 percent, according to the Eurekahedge Hedge Fund Index, which includes around 2,800 funds with multiple regional mandates.

Looking ahead into 2017

We see another positive year for risk-assets and are recommending clients to maintain a very similar asset allocation. As we experience the end of the quantitative easing era, in a very late stage of the economic cycle and with high political risks, there is a higher likelihood of boom and bust:

1. We are in the ninth year of this **long economic cycle** and equity bull-market.
2. **Valuations** are not cheap, with the forward multiple of the S&P 500 trading at 17.7x forward EPS.
3. Markets are enthused about the prospect of **deregulation** of the financial industry, tax reform and tax cuts for both individuals and corporations, increased infrastructure spending and healthcare reform.
4. While we are positive regarding the effects of Trump's "supply-side" pro-growth economic policy agenda, there are some risks, mainly regarding **trade policy**, which we see as a **key market risk.**

Bank Divergence in 2017 Market Forecasts

In the short-term, that is 1-2 months' time, many analysts believe that the market is overbought and can expect a sell-off due to realization of capital gains in 2017. People have been holding-off during 2016 due to the expectation that Trump would lower capital gain taxes, giving on-shore investors an incentive to hold-off. However, for our offshore clients, who have no upcoming taxable event, cashing in profits from this year's rally seems like the logical move to make. The S&P 500 is extended and it has seen a broad rally across sectors. Remember for example that Financials were the only sector in negative territory on Election Day, and now they are +20% year-to-date.

Given the fact that we have stated our Market Forecast for 2017, we would also like to share the forecasts put forth by some of the leading financial institutions. These forecasts show a wide range of potential outcomes between bullish and bearish scenarios (see right table for base cases). The divergent outcomes reflect the potential risks and rewards that could arise from domestic and global political uncertainties, as well as the shift back to "normal" interest rates and monetary policy.

S&P 500 Forecast for end of 2017	
J.P. Morgan	**2400**
Societe Generale	**2400**
Deutsche Bank	**2350**
Citigroup	**2325**
Bank of America Merrill Lynch	**2300**
Credit Suisse	**2300**
Goldman Sachs	**2300**
Morgan Stanley	**2300**
UBS	**2300**
BNP Paribas	**2250**

Financial Times

One of the clearest examples of this divergence can be seen in the outlook delivered by Goldman Sachs. The investment bank expects the Trump Rally to continue further, taking the S&P500 to 2,400 within the first 100 days of Donald Trump's presidency. For their year-end figure though, Goldman retreats to a more conservative 2,300 given possible contentious battles in Congress to pass a Trump agenda and the global implications of his actions.

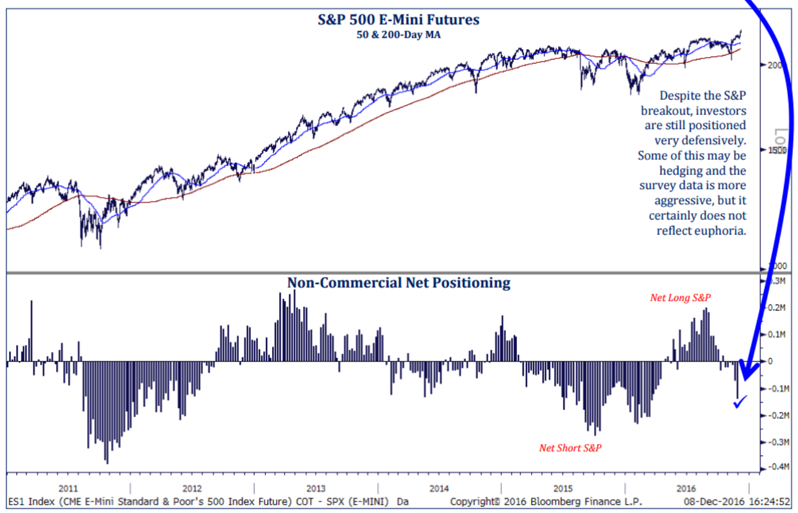
Other views: Morgan Stanley peg the S&P 500 index at3050 under a bull scenario, while its bear case puts the index at 1625. Bank of America Merrill Lynch likens **2017 to "an erratic bird with fat tails," predicting a bull case that puts the S&P 500 at 2700 and a bear case at 1600.**

BigSur's Market Views

Our Investment Committee predicts mid-single-digit total returns for the S&P 500 in 2017, with a Base-Case December 2017 target of 2400-2450 for the index in a year characterized by volatility and tension between higher earnings and lower multiples. Additionally, it's a healthy sign that rates are finally resuscitating from the depths of deflation fears. However, when 10 year yields are below 5%, modest increases in interest rates have historically helped stocks.

Our colleagues and friends from Strategas have revised their estimate for CY'17 S&P 500 EPS up to $123.75 from $111.75. Corporate profits have been flat for three years running (approx. $118 in CY'14-'16) and we had been of the view that this pace would continue through 2Q'17 before tailing off as end-of-cycle pressures mounted in 2H'17 against difficult comps. "The facts have changed" says Jason Trennert. "The recent shift in revenue growth back above the zero-bound, in combination a steepening of the credit and earnings curves should lead to an improvement in operating leverage and result in higher corporate profits for next year." Another important fundamental is that market positioning for the medium term for the S&P500 remains DEFENSIVE, even if market sentiment has recently surged.

SURPRISING… INVESTORS REMAIN POSITIONED DEFENSIVELY



Strategas Technical Analysis

Political Risk and Market Volatility

The market has experienced a tectonic shift from its position this past summer, when treasuries were yielding historic lows and foreign governments were borrowing money for 50 to 100 years and charging interest in the process. We are beginning to see a further shift to a "normalization" of interest rates and monetary policy, removed from the crutches of central banks that have helped prop up markets. Many analysts see this transition to fiscal support as bumpy and bringing about a wide range of potential outcomes. The Trump rally could peter out as monetary policy "normalizes." In 2017, it will be crucial to closely monitor volatility indices like VIX, Credit-default-swaps, FX volatilities and others given the uncertainties that remain Clients who have a plan to take advantage of volatility and are prepared to react will once again come out on top.

Brexit and the Trump triumph highlight the decline of the party system and the end of the old left/right divide. The center-left appears in terminal decline. The Conservative or Christian Democrat center-right fared better, but remains under pressure from an anti-immigrant, nationalist fringe, from Austria to England, France, Germany, Hungary, the Netherlands and, increasingly, Poland.

In 2016, we witnessed the birth of a new brand of politics that is nativist, protectionist and bathed in a cultural nostalgia captured by Trump's pledge to "Make America Great Again." This disappointment has translated to the emergence of unlikely "outsider" candidates taking center stage in countries like the United States, France and Italy, just to name a few.

De-globalization

The Financial Times points out that 2016 saw an end to this period coined "Globalization 2.0". Fueled by a widespread disappointment among western democracies with the postwar phenomenon marked by three trends: the Roaring Eighties deregulation of the Reagan-Thatcher era; the 1994 Uruguay Round agreement on global trade liberalization; and the opening of a market economy in China.

Trump has proposed severe tariffs of 35% and 45%, respectively on imports from Mexico and China, which are America's largest sources of imports in dollar terms. Cato Institute trade expert Dan Ikenson stated that these tariffs "would be devastating to the U.S. and global economies and would destroy the international trading system." Many predict the result would be a global recession and a bear market in stocks. It is important to keep in mind that any aggressive move by the White House to hike tariffs will get pushback from a Republican-dominated Congress that has traditionally supported trade liberalization.

While protectionism could have a negative impact on the global economy, the effects on the U.S. economy would probably be modest given the fact that it remains a relatively closed economy. Exports account for only 12% of GDP, and most of these are intermediate goods that are processed or reshipped back to the U.S. or another market, therefore placing tariffs or trade barriers to American exports would end up hurting economies like Mexico and China much more.

Time to look at Small Cap stocks again

The transition from the aforementioned globalized to protectionist political agenda should fare well for domestic companies in the United States, therefore we have increased our allocation to Small Caps from an underweight to overweight. While we acknowledge that Small Caps have performed well this year, especially since the election, we believe they can continue to outperform. As they have more advantages, based on expectations for higher growth and lower taxes.

Small Caps generate a higher portion of revenues from US-based business than do Large Caps and therefore are less exposed to challenges that may result from increased protectionism or restrictions on trade. Merrill Lynch strategist Subramanian points out Small Caps have higher median tax rates than Large Caps and are poised to benefit more from lower corporate tax rates, should those be part of upcoming policy changes.

Fixed Income Markets in a Divergent Monetary Policy Environment

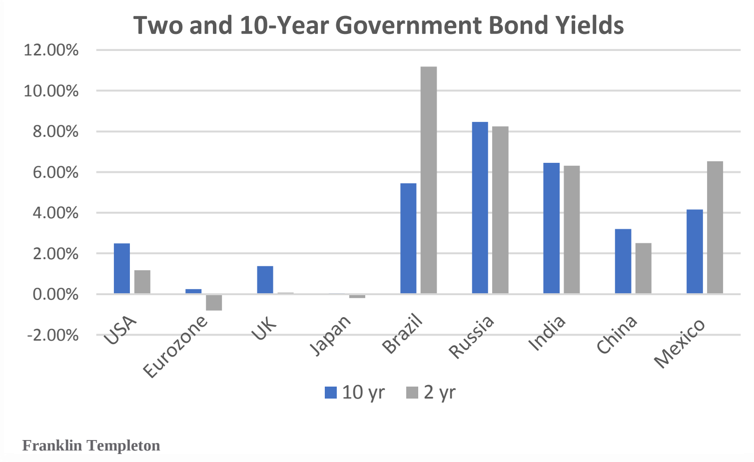
Monetary policy in both the euro-area and Japan diverge markedly from the U.S. path. We share the view of Franklin Templeton's Global Macro chief, Michael Hasenstab, Ph.D.: "Throughout much of 2016, bond markets held onto stretched valuations in U.S. Treasuries, largely ignoring the undercurrents of rising inflation and resilient strength in the U.S. labor market. During the first half of the year, there were even a number of market participants arguing that inflation had become structurally lower and that deflationary risks were of great concern. We believed there are exceptional vulnerabilities in U.S. Treasury valuations, and as such we have been very underweighted, with most investors avoiding being long direct Treasury risk." However, we do prefer US Treasuries to Bunds or JGBs.

The good news is that bonds offer considerably better income potential now than during the summer. The bad news is that the prospect of a further rise in yields brings the risk of additional price declines. Given these reasons, we like **investment grade corporate bonds** because they are high quality and give a decent yield pick-up over Treasuries. Presently, the yield spread of investment grade corporate bonds over Treasuries is 1.3%. Shrinking supply, strong demand from foreign investors and improving fundamentals will all benefit corporate bonds.

We also think that the bad news is priced in the **muni market;** since it has overreacted to the potential changes coming from the Trump Administration, creating an opportunity for investors to receive tax-exempt income. One concern is that income tax cuts will diminish the appeal of the tax exemption of municipal income. Trump has proposed a top tax rate of 33% and House Republicans have proposed excluding half of interest income from taxation. But we don't see that as a threat. Even with much lower tax rates, municipals still would have better yields than the after-tax yield on Treasuries for people in the top bracket.

Preferreds got hit hard after the election, but less so than long-term Treasuries. If Treasury yields rise during the first half of 2017, as we expect, prices for preferreds will probably decline further. But the income on preferreds will offset some of the losses, and if rates stabilize in the second half of the year, returns should improve. We think that fixed-to-floating rate preferreds will perform better than pure fixed-rate preferreds. **We would focus on floating rate notes and fixed to floaters preferreds.**

Emerging Market: Credit over Equity



There has been a major post-election divergence between U.S. and EM assets. U.S. stocks, yields and inflation expectations look consistent with a scenario where the U.S. embarks on fiscal easing, avoids protectionism and sees the Fed hike slowly. EM bonds and stocks, in contrast, have given back half their YTD gains since the election. We think that's an overreaction, especially for fixed income, and expect an opportunity to scale into EM hard currency debt in the first half of 2017 given that:

1. EM remains an improving macro story on forecasts from leading financial institutions.
2. Relative to 2016, growth will be higher, inflation will be lower and policy will be easier.
3. Vulnerabilities are lower than during the 'taper tantrum', with better C/A balances and higher real rates than three years ago.
4. Valuations are supportive.

Rising U.S. Inflation Pressures in 2017

As inflation begins to pick up, we recommend investors to gain exposure to the U.S. Treasury market through **TIPS or Inflation-Protected-Securities** and not via regular Treasuries. Our case for rising inflation in the US is primarily centered on rising wage pressures across a U.S. labor force that has been at full employment for much of 2016 and continues to strengthen, accompanied by a fiscal policy set to expand. Core CPI (Consumer Price Index) inflation has persisted above 2.0% throughout 2016 and shows signs of continuing to trend higher. We expect headline inflation to rise above 3.0% in early 2017 as the base effects from last year's decline in oil prices fall out of the figures.

In the event that the incoming administration imposes trade restrictions and tariffs, this would also drive up the costs of goods in the U.S. Taken together, we expect inflation to exceed the U.S. Federal Reserve's (Fed's) target by early 2017 and believe the Fed needs to continue to hike rates most probably 3 times for a total of 0.75% during 2017.

FX Views: 2017 looking strong for the greenback

Rising yields in the U.S. were accompanied by depreciations of the Japanese yen and the euro. As we look toward 2017, we expect many of those underlying conditions in developed economies that were rapidly driven back into market pricing in late 2016 to only deepen and extend. 2017 is still looking strong for the greenback. The best FX strategists we follow expect the recent strengthening of the USD to continue, with the broad USD index expected to gain 6% over the next year and top out in 2Q18, driven by widening rate and investment return differentials. Within G10, JPY is expected to see the most weakness due to easing monetary policy and rising global inflation expectations.

The EUR/USD rate is also expected to continue its downward path, as inflation remains low and the market continues to be wary of Eurozone break-up risks, while GBP is likely to reach the low-point in 1Q17, as the UK government triggers Article 50. EM currencies should have an environment of pressure as rising US bond yields on the back of higher growth and inflation expectations will widen yield differentials in favor of the US and against EM currencies, such as CNY.

Conclusion

In summary, we believe risk assets are in line for another positive year, although with stronger and more pronounced market movements. Our recommendation to clients is to keep calm and carry on, but to maintain increased levels of cash in order to tactically respond to these volatile movements.

We continue to prefer stocks and credit over high grade government fixed income (2016 was the year of negative developed markets government rates, but the trend has turned); continue to like revenue producing private investments; continue to use around 20% of a portfolio for tactical opportunities in an increasingly volatile stage of the cycle and the market.

Investors will pay-off to be invested, yet we are predicting sharper and more frequent market movements in both directions, primarily driven by political risk, amongst others With the recent "No" vote on the Italian referendum, UK setting Article 50 in motion, and upcoming elections in Netherlands, Germany, France and Italy where populist forces look to thrive, investors will be watching their impacts on global economic growth.

In the long term, the most relevant question is if Trump can pull off a structural—as opposed to merely cyclical—improvements? **Productivity of our overall economy has grown at the most lethargic pace of any expansion since World War II due to the daunting forces of demographics, debt deleveraging, and deflationary pressures from automation**. If Trump succeeds in making our economy much more productive, he would have earned the right to affix his name to one of the more enduring expansions of our time.

The big issue is whether Trump's tax cuts and spending spree will actually raise potential growth or simply shorten the economic cycle. Any short-term lift to growth will come with a shortening of the economic cycle, rather than an increase in US economic growth, and therefore bring the date of the next US — and global — recession somewhat closer. **We are cautiously optimistic, especially with the recent nominations for economic policy.**

Please see the next page for our Strategic Asset Views[3].


Underweight
Neutral
Overweight
Cash
Cash
Cash
Fixed Income
FI
High Grade
Developed (USD)
Developed (non USD)
Emerging Market Debt
High Yield and EM Debt
Hybrids & Perpetuals
H&P
Hybrids & Perpetuals
Equity
EQ
US Equity
Europe
Japan
Emerging Markets
Alternative Investments
AI
Hedge Funds
Commodities
Gold
Real Estate
Private Equity
Private Debt
Additional Views
FX
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Bunds
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