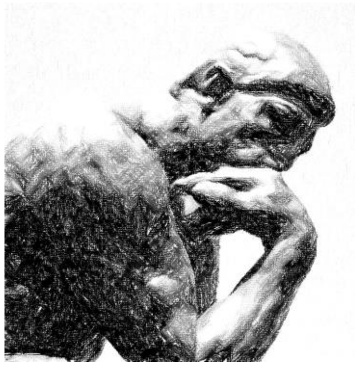
# 2017 Review and Forecast

The Thinking Man's Approach



August 2017 | Series #50
Ignacio Pakciarz, CEO
Salvador Juncadella, Analyst
Eduardo Sensel, Analyst

Investment Recommendations:

- Investors should have at a minimum a 10% cash allocation.
- We recommend holding only "triple plays", meaning blue-chip companies that beat both earnings and revenue estimates in Q2'17, and guided future earnings estimates higher.
- Diversification continues to be the only "free lunch" in financial markets. We believe clients should increase alternative investment exposure.
- We recommend creating a hedging portfolio to take advantage of historically low volatility levels.
- We believe clients should avoid areas of turmoil, such as retailers, supermarkets and automakers.

For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com

## *Goldilocks Economy*

In the beginning of the year, BigSur's Investment Committee forecasted that 2017 would usher in the higher probability for a "boom and bust" in financial markets. Our reasons were that this economic cycle had just entered its ninth year of expansion (the second longest expansion in history), the political landscape in both the U.S. and Europe remained uncertain, and equity valuations were already extended.

Markets have continued pushing up, breaking record after record throughout the first half of the year given the extensive pro-growth policy agenda that was set forth by President Trump, which included: deregulation in the financial and healthcare industries, tax reform for individuals and corporations, and increased infrastructure spending. Expectations for these reforms persist, yet none of the policy agenda items have materialized. Hopes of a significant boost to the economy from a change in policy have been discounted by the market, except for tax reform, which we believe could catalyze the markets.

Weakness in the economic policy agenda has been counterbalanced by stronger than expected earnings growth, both domestically and abroad. The U.S. is currently experiencing a "Goldilocks" economy, driven primarily by accommodative central bank policies, rising corporate profits and historically low volatility. Slow and steady growth has produced a long stretch of job creation, leaving the economy on mostly stable footing. In July, the U.S. posted a record 82nd straight month of job creation and an unemployment rate at a 16-year low.

These positive numbers have pushed volatility indexes down to their lowest levels in over 30 years, but we believe there exists a great deal of uncertainty that is not being priced into markets. An example of this uncertainty was recently witnessed when tensions between the U.S. and North Korea caused the VIX to spike almost 45%. Within the next two trading days though, markets recovered their losses, and volatility quickly fell back to lower levels. This move reflects investors' tendency to buy stocks following any pullbacks – a mentality that has helped limit both the scale and duration of stock downturns.

The leading global investment banks have pegged the probability of a recession at a mere 15%, according to a recent survey conducted by the Wall Street Journal. Although stocks may be fully valued, this stock boom lacks other booms' fervor and overlook of companies' fundamentals. The U.S. equity market currently trades at about 18x future earnings, which is higher than the average historical multiple; however, on a relative basis to bonds, they remain attractive. History has shown that valuation indicators such as price/earnings, price-to-book, price-to-sales, or price-to-dividends ratios are notoriously poor at identifying market tops.

Our view is that an inflection point is still a year or so away, and that it is therefore too soon to de-risk portfolios. This view is in line with that of BCA Research: "Our best guess is that a recession is at least 18 months away, and that corporate earnings will continue to grow at a robust rate over the rest of the year. Conditions do not yet merit a retreat from equities, and investors who de-risk too soon risk lagging their benchmarks and their peers."

## *Earnings*

We believe the stock market still has room to run primarily because of earnings. Investors were pleasantly surprised by the strength of earnings results in the U.S. and Europe, shrugging off political uncertainty and placing their faith in continued global growth.

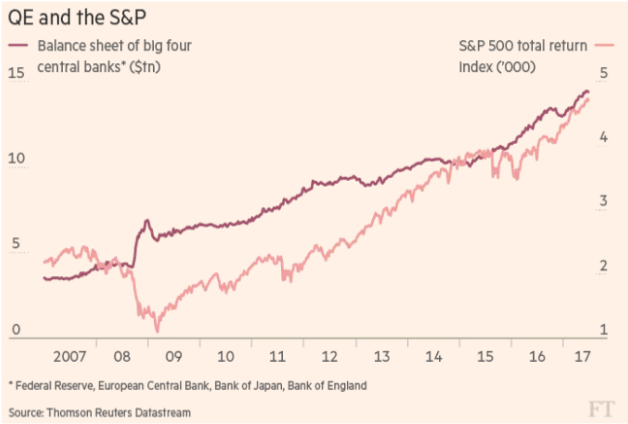
### United States

The U.S. experienced consecutive double-digit profit growth in the first two quarters of 2017, with the S&P 500 increasing 15% in Q1 and 11% in Q2. These strong earnings results are the product of years of cost-cutting, a weaker USD and stronger consumer spending. Corporate managers have been creative in expanding what was considered toppish profit margins, and the weaker dollar has helped propel revenues.


Since the presidential election, the S&P 500 has risen over 16%. It can be argued that investors overestimated Trump's ability to implement policy, but greatly underestimated earnings growth. The strong corporate results are coming amid political gridlock in Washington, as policies that were expected to help companies' bottom line have not been passed. Political uncertainty continues to make companies reluctant to invest until there is more clarity on specific policies. Tax reform is clearly what the future requires for earnings to continue their same pace, and for corporate investments to rise. A tax overhaul will be very difficult to pass in the current political environment. However, there is a strong possibility that within the next six months, the administration can reduce the corporate tax rate and introduce a business-friendly plan for repatriating assets. These events can be very meaningful to earnings, especially if the corporate tax cuts go from the current 35% level to the low 20s.

## Europe

In Europe, the equities rally was reignited by improvements in both the economic and political environments. It has been easier for European companies to expand profit margins relative to their American counterparts given that the region is in an earlier stage of the economic cycle, translating into more room for growth. European earnings grew 25% in Q1 and 16% in Q2, propelling the Eurozone to experience its first full year of earnings expansion in six years. Many analysts believe earnings growth in the Eurozone will continue to surpass that of the U.S. for the remainder of 2017, and all of 2018. This turning point in market leadership is driven by lower valuations, aggressive monetary accommodation, improving labor markets and economies.




In regards to the political environment, what was expected to be a series of volatile elections driven by the rise in nationalism ended up being "non-events" for markets. Of these elections, the most important was the victory of Emmanuel Macron in France, which eased fears about the spread of populism across the continent, as well as an exit from the common currency. Another major concern across Europe was the dangerous leverage ratio present in Italian banks, which have improved.

## *Global Monetary Policy*

We are beginning to see a further global shift to a "normalization" of interest rates and monetary policy, removed from the crutches of central banks that have helped prop up markets. Favorable monetary and fiscal policies substantially reduce the probability of a recession in key developed and emerging market countries.

The direction and magnitude of change of yield curves may provide early signs of building overtightening risk, with the U.S. curve most critical. The flattening of the U.S. curve this year indicates overtightening risks may be rising. However, with the curve still well in positive territory, it is flashing amber rather than red in our view. We believe that equities can continue supporting higher valuations, even if the 10-year Treasury bond yield was to rise 150 basis points to 3.75%.

Global equities have benefited from suppressing bond yields and from a very supportive tide of liquidity caused by central bank's $14 trillion of quantitative easing (QE). As central banks begin to sell assets in order to normalize markets, there could potentially be a repricing in the bond market which could carry on to affect equities. Many analysts predict that the next market correction will be caused by the bond market. We believe that a pop in the "bond market bubble" will only occur given strong inflationary pressures, which have yet to be seen. Soft U.S. inflation readings for the past four months have even caused analysts to ratchet back expectations for future Fed rate hikes.

Given the fact that central banks will likely take their time withdrawing stimulus, there could potentially be further room for equities to run higher until then. Since inflation has been so contained, central banks can manage normalization on an extended time frame, withdrawing liquidity very carefully. Central banks will need to be ahead of the markets when announcing hikes if they want to avoid crashing the markets and the global economy.

## *Mixed Signals*

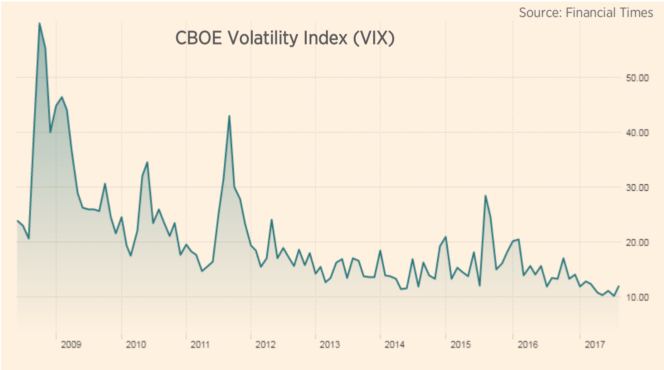
There are many key indicators that are presenting mixed signals in terms of where the market is headed. We believe one of the top causes of divergence is the negative view investors have towards the ability of governments to implement business-friendly policies, while maintaining a bullish view on global growth continuing its push forward.

### Diverging Economic Indicators

The trend lines clearly show that consumers have become increasingly confident about both their current and future prospects. Confidence levels are currently sitting at a 16-year high, with Americans drawing encouragement from an economy that continues to provide jobs, rising stock and home prices and steady pay gains. That confidence though has not yet translated into increased consumer spending and business investment, meaning they are not putting "their money where their mouths are". Spending and investment will likely remain on the sidelines until policy is clearer.

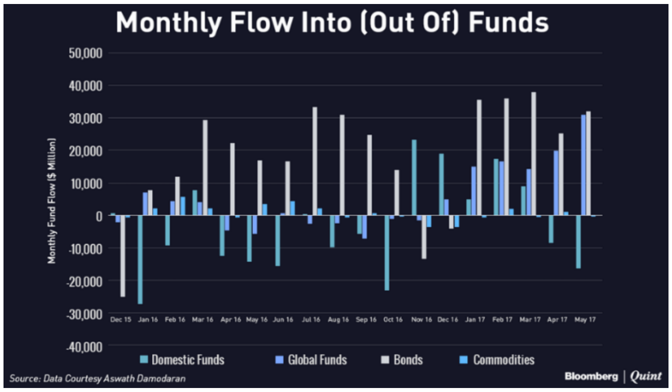
### Diverging Risk Indicators

The market seems to be signaling a period of unusual stability, with volatility measures in both the U.S. and Europe reaching historic lows, yet if you turn on the news, the world seems to always be on the brink of chaos. On the other hand, policy uncertainty indexes have spiked multiple times, breaking records set during the 2008 crisis. They seem to be warning of a period of high volatility for global economies.




### Diverging Technical Indicators

Fund flows have historically been one of the best measures of how comfortable investors feel about risk. More money has flowed into equity and bond funds, on a monthly basis, since November 2016 than in the first ten months of 2016. This is consistent with the drop in volatility. However, money is leaving U.S. stocks and moving into European stocks. Money going into U.S. stocks is at a 9-year low, while inflows into European stocks recently hit a 5-year high.




## *Our Base Case*

We believe markets still have some room to run, therefore it is important to remain invested in the short-term. Our reasoning for markets continuing their upward momentum is the fact that that fundamentals remain strong, even in this late stage of the economic cycle. We are carefully monitoring data points that could signal exuberance in financial markets, primarily the risk in rising valuations, the loss of momentum in U.S. reforms, and the rise in geopolitical risk that has been overlooked by investors for far too long. We recommend the following investment advice in coordination and consideration of individual investor characteristics:

1. Being patient is important. Investors should have at a minimum a 10% cash allocation.

2. It is more important than ever to review each individual security in a portfolio. Top quality assets, or "blue-chips" are the most resilient. We recommend holding only those stocks that are "triple plays", meaning companies that beat both earnings and revenue estimates in Q2'17, and guided future earnings estimates higher.

3. Diversification continues to be the only "free lunch" in financial markets. We believe clients should increase alternative investment exposure, particularly by building a portfolio of illiquid and uncorrelated "niche" private investments that can continue to perform well even through a market downturn.

4. The only cheap security available to investors has been volatility. We recommend, when appropriate, creating a hedging portfolio to take advantage of these historically low levels, primarily buying put spreads on SPX.

5. Prudence is the best approach to navigate this market. The smartest move is to identify areas of instability and stay far away from them. We are believers in avoiding areas of turmoil - market sectors under "tsunamis" - such as retailers, supermarkets and automakers.

## Important Disclosures

This material is distributed for informational purposes only. The discussions and opinions in this article are for general information only, and are not intended to provide investment advice. While taken from sources deemed to be accurate, BigSur Wealth Management, LLC ("BigSur" or the "Adviser") makes no representations about the accuracy of the information in the article or its appropriateness for any given situation. Certain information included in this article was based on third-party sources and, although believed to be reliable, it has not been independently verified and its accuracy or completeness cannot be guaranteed. Any statements regarding future events constitute only subjective views or beliefs, are not guarantees or projections of performance, should not be relied on, are subject to change due to a variety of factors, including fluctuating market conditions, and involve inherent risks and uncertainties, both general and specific, many of which cannot be predicted or quantified and are beyond our control. Future results could differ materially and no assurance is given that these statements are now or will prove to be accurate or complete in any way. This article may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. BigSur shall not be responsible for the consequences of reliance upon any opinion or statements contained herein, and expressly disclaim any liability, including incidental or consequential damages, arising from any errors or omissions.

The companies discussed herein, are for illustrative purposes only and do not represent past or current recommendations by BigSur. This article is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific investor. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. Any securities or products referenced BigSur believes may present opportunities for appreciation over the subsequent time periods. BigSur closely monitors securities discussed and client portfolios and may make changes when warranted as a result of evolving market conditions. There can be no assurance that the securities and performance included or referenced in the article will remain the same and investment strategies, philosophies and allocation are subject to change without prior notice. Specific securities or companies identified and described may or may not be held in portfolios managed by the Adviser and do not represent all of the securities purchased, sold, or recommended for advisory clients. The reader should not assume that investments in the securities identified and discussed were or will be profitable. BigSur may change its views on these securities at any time. There is no guarantee that, should market conditions repeat, these securities will perform in the same way in the future. Any referenced securities and their respective returns reflect the reinvestment of income and dividends, but do not take into account trading costs, management fees, and any other applicable fees, expenses, and various factors including account restrictions, guidelines, the timing of investments, and cash flows that may affect the investor's actual return and performance. Please refer to Part 2A of BigSur's Form ADV for a complete description of fees and expenses. Hypothetical performance results may have inherent limitations.

The returns and references to the S&P 500 index are provided for informational purposes only. The S&P 500 Index is a market-capitalization weighted index containing the 500 most widely held companies chosen with respect to market size, liquidity, and industry. The index is calculated on a total return basis with dividends reinvested. In addition, the volatility and securities of the index may be materially different from an investor's. The S&P 500 Index was selected and is referenced to allow for comparison of the performance of any referenced securities or overall market to that of a well-known and widely recognized index. Comparisons to indexes in this material have limitations because indexes have volatility and other material characteristics that may differ from the referenced strategy or security. Therefore, actual performance may differ substantially from the performance of any referenced index). Investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Due to these differences, indexes should not be relied upon as an accurate measure of comparison and are for informational purposes only. Unless noted otherwise, all index returns are denominated in U.S. dollars.

Target exposures included in this article may differ between clients based upon their investment objectives, financial situations and risk tolerances. Investments in general involve numerous risks, including, among others, market risk, default risk and liquidity risk. No security or financial instrument is suitable for all investors. Securities and other financial instruments discussed in this article, are not insured by the Federal Deposit Insurance Corporation ("FDIC"). The income and market values of the securities stated on this article may fluctuate and, in some cases, investors may lose their entire principal investment. Past performance is not indicative of future results.

This information is highly confidential and intended for review by the recipient only. The information should not be disseminated or be made available for public use or to any other source without the express written authorization of BigSur. Such distribution is prohibited in any jurisdiction dissemination may be unlawful. Please contact your investment adviser for advice appropriate to your specific situation.