January 20, 2017

Dear Clients and Friends,

What will 2017 hold? The future is unknown. Yet, the worst possible outcome is not the most likely one. It is something I often remind myself of, as I am in the business of assessing risk when investing my clients' money. Risk – or the possibility of adverse outcomes – should not be ignored, obviously, but it is the flipside of reward. You can't have one without the other. So, with eyes wide open but glass half full, let us look at what may lie ahead.

A stock market correction: it's entirely possible that one will happen. It is defined as a decline greater than 10% and has happened on average once every 2 years since 1945, though not neatly spread out in 2-year increments. We had one in early 2016 and before that, October 2011. We will have one again at some point, I am sure of it. It does not alter investment decision making, because you don't know when it is going to happen. And if you wait to invest until the next correction, what are you going to do about the next one, and the one after that?

Political risk: leading up to the election, the consensus was that a Trump victory was unlikely and if it were to happen, it would crash the stock market. It did happen and the market rallied. 0-2 for the consensus. Those investors who correctly predicted the outcome of the election, probably lost money as a group, as they positioned their portfolios for a downturn. Those who predicted Hillary would win, got it wrong, but probably did ok in their portfolios. Letting politics drive your investment decisions feels like a bug looking for a windshield, in my opinion.

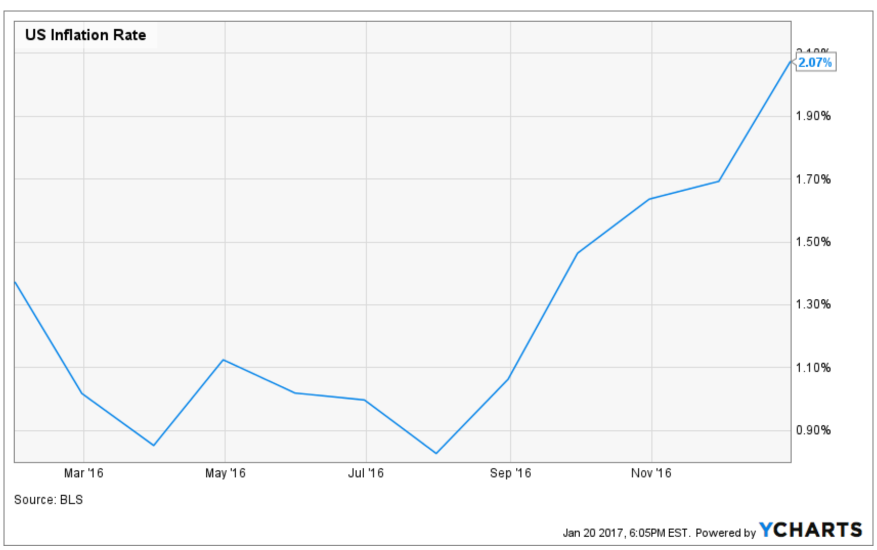
I find it equally puzzling that the consensus is now driven by some kind of euphoria that we are entering an era in which the US economy is going to unburden itself of taxation, regulation, and fiscal constraint and that the US economy will grow at rates not seen in decades. With an aging population, US growth is mostly driven by productivity growth, which even if it increases as a result of government policy, it is unlikely to be dramatically different from the recent past.

If companies earn more, they will probably pay out more to their investors rather than spend more on R&D and make capital investments. That in-turn, does not lead to higher growth. But even if it did, we can't ignore all the things that could go wrong, such as geopolitical missteps, trade conflicts, and reduced immigration of highly skilled workers and future entrepreneurs. To my earlier point, I don't expect the worst possible outcomes to be the most likely, but I feel the current investor consensus lacks balance and is looking through rose-colored glasses.

Diversification: For the last 5-7 years it has not worked so well, as the US stock market has topped the charts year after year. But it would be a mistake to assume that US stocks will forever earn the best returns. In the words of American economist Herbert Stein: "If something cannot go on forever, it will stop." From 2003 to 2007 Emerging Markets were the best performing asset class and International Developed Markets did not lag far behind. Things change. We know for a fact that we cannot predict with certainty which asset class will do best, and that's why we are wise to own more than one.

Pension funds are a good example of diversified investors and they have lagged the US stock market returns in recent years. Not because they are poor managers, but because they are diversified. For example, for the year ended 6/30/2016, the Yale endowment returned 3.4%. Nothing to get excited about, but consider that they only had 4% allocated to US stocks. The Yale endowment believes in diversification and the flipside of that, is that if they only have 4% in US stocks when US stocks are the top performing asset class, they are going to lag. But Yale is not interested in besting the US stock market in any one year. They are playing the long-game and over the last decade they have averaged 8.1%, outpacing the markets, as well as their endowment peers.

Outlook: Lacking a crystal ball is not my excuse for refusing to express my views of what may lie ahead. I do have an opinion on a few matters. One opinion I hold, is that inflation will pick up a little. Or in Wall Street parlance, I believe in the reflation trade. The current administration is likely to spend material sums of money on infrastructure and the military, while cutting taxes. That amounts to a hefty dose of fiscal stimulus, which in turn could lead to a pickup in inflation. At the same time, the labor market is tightening and energy prices have increased from record lows. Both these trends support higher inflation. I don't think that means that interest rates are going to rise dramatically, but they could tick up a bit. In fact, it wouldn't be altogether disastrous to have slightly higher interest rates, so that retirees could elect to invest more in lower risk bonds without sacrificing returns and retirement income.



The other view I hold, is that emerging markets and international markets will return more over the next 5-7 years than will US markets. The reason I believe this, is not a lack of confidence in the US economy, which is still without peer when it comes to dynamism and resilience. Rather, it is a belief in mean reversion and growth. Many overseas economies, especially in emerging markets, are likely to exhibit higher growth over the next decade than our more mature economy will. Furthermore, these stocks are cheap and denominated in cheap currencies. Mean reversion, or stock prices and currencies going back to longer-term averages, would imply a 2-3% tail wind per year over the next decade. You will have to hold on to this newsletter and hold me accountable in 2024 if it turns out that I was wrong.

The future of renewable energy: I don't believe the new administration heralds the end of the renewable energy industry. I am more worried as an environmentalist than as an investor in cleantech and renewable energy. What I mean by that, is that the smoke stack economy and fossil fuels will get a shot in the arm, but that it will be short lived and that it won't stop the growth of renewables. The fossil fuel age is already on its way out and a temporary counter reformation of the energy landscape is not likely to last. In 2015, 23% of global electricity generation came from renewables and over the next 5 years, 60% of the global increase in electricity output is projected to come from renewables, according to the International Energy Agency (IEA).

Finally, there is one prediction I am absolutely certain of: because it is the Year of the Rooster this year, I predict that next year will be the Year of the Dog. In that year, we are supposed to show tolerance and empathy towards the people we meet. I look forward to it.

I welcome you to contact me with any questions or to learn more about our investment strategies and financial advisory services.

Kindly,

Jan Schalkwijk, CFA

JPS Global Investments