Berman Capital Advisors

April 21, 2017

BCA Q1 2017 Investment Review

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Summary Outlook

- Despite global and domestic political tensions, earnings momentum and rising confidence position “risk” assets to perform well this year.
- Markets concerns have shifted: less worry about protectionism, rising interest rates and geopolitical tensions, and more worry about global economic strength. We think the evidence points to a resumption in economic growth momentum.
- Partly because the post-crisis recovery has been slow, economic and credit cycles continue to expand. Thus, this unusually long market cycle can continue.
- We believe a strong focus on nontraditional and private opportunities is still warranted: traditional bonds are unattractive and many parts of the equity universe are expensive.

You have often heard us comment that quarter-end index returns masked market swings in the meantime. Not in the first quarter, when stocks set a record for days without a 1% move. Volatility stayed consistently low despite the new President’s spate of executive orders, Congress’ failure to repeal and replace Obamacare, the Fed’s third interest rate hike and a sharp reversal in crude oil. Recently, investor optimism has matched that of consumers. The S&P 500 Index rose 5.5% in 1Q17, its best start to the year since 2013 and third best since 2000.

	Index Total Return in US$	
Index	Q1 2017	Q4 2016
MSCI Emerging Markets	11.4	-4.2
Russell 1000 Growth	8.9	1.0
MSCI Europe	7.4	-0.4
MSCI EAFE (International)	7.3	-0.7
S&P 500	6.1	3.8
Russell Midcap	5.2	3.2
Japan	4.5	-0.2
Russell 1000 Value	3.3	6.7
High Yield Bonds	2.7	1.8
Russell Small Cap	2.5	8.8
US Aggregate Bond	0.8	-3.0
Crude Oil	-5.8	12.3

Source: Bloomberg, Ned Davis Research

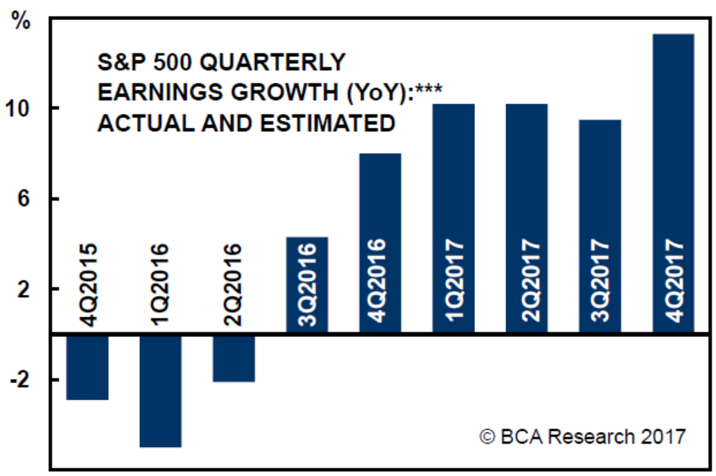
Note: International market returns reported in U.S. Dollars

In equities, the previous quarter’s winners and losers switched places. Large-caps outperformed small-caps, with the Russell Top 200 Total Return Index outpacing the Russell 2000 Index by nearly 4%. Growth outperformed Value across the capitalization spectrum as cyclical stocks underperformed. We still expect cyclicals to outperform for the full year in 2017. Thanks to a weaker U.S. dollar, the MSCI EAFE (Developed International) and Emerging Market Indexes outpaced the S&P 500, returning 7.2% and 11.4%, respectively.

Bonds were boring this quarter, as the float adjusted U.S. Aggregate returned 0.85%. The LSTA bank loan index (floating rates) added a similar 0.79%. U.S. dollar-denominated emerging market bonds gained 3.3%, while U.S. high yield gained 2.7%.

Despite Worries on Global Reflation, Earnings Set to Rise

After rallying hard following the U.S. presidential election, risk assets have stalled since early March. The S&P 500 has fallen by 1.8% after hitting a record high on March 1st. Treasury yields have fallen and credit spreads have widened modestly. Gold has recently had a strong run. Investors wonder whether this is a strong market taking a breather, or if these moves anticipate economic weakness. So far, the evidence points to stronger growth ahead. We believe the market has been willing to look past Trump administration setbacks and geopolitical tension because earnings momentum is still strong. If this comes into question, domestic and international tensions will become more than just noise.



* SHOWN SMOOTHED.
** GDP-WEIGHTED SUM OF THE U.S., U.K., EURO AREA, AND JAPAN. SOURCE: GOLDMAN AND SACHS, BLOOMBERG FINANCE L.P., AND IMF.
*** SOURCE: THOMSON REUTERS.

This past year, we have tilted portfolios toward smaller capitalization and value sectors, which tend to be more economically sensitive. This positioning was helpful last year, but has underperformed in the first quarter. Nonetheless, we still think tilting toward these positions will add value. Economic growth and rising interest rates usually mean cyclicals will do well, particularly energy and financials. In contrast, more defensive, stable investments typically underperform when growth strengthens.

Trump's faltering agenda has contributed to the pullback in cyclical investments. Indeed, failure to make progress on a meaningful tax package and infrastructure plan could prompt the first 5%+ U.S. equity market correction in the Trump era. Yet the lack of excesses in the economy, agreement between the Fed and the market on the path of rates for this year and rising but controlled inflation are likely to make pullbacks in U.S. stocks a buying opportunity.

However, even if Republicans are unable to overhaul the tax code, this will not prevent them from simply cutting corporate and personal taxes. Worries that tax cuts will lead to larger budget deficits will likely be brushed aside on the grounds they will be significantly offset through faster growth (probably unlikely). With some bipartisan infrastructure spending in the mix, it will not take much for the "Trump Trade" to return.

How this plays out is a risk, but that impact is down the road. If the past is prologue, tax cuts may end up having a disappointingly small impact. The highly profitable companies that will benefit the most from lower corporate taxes are the ones who least need them. In many cases, these companies have plenty of cash and easy access to external financing. Therefore, much of the tax cuts will simply be hoarded or used to finance equity buybacks or dividend payments. A large share of personal tax cuts will also be saved, given that they will mostly accrue to higher income earners.

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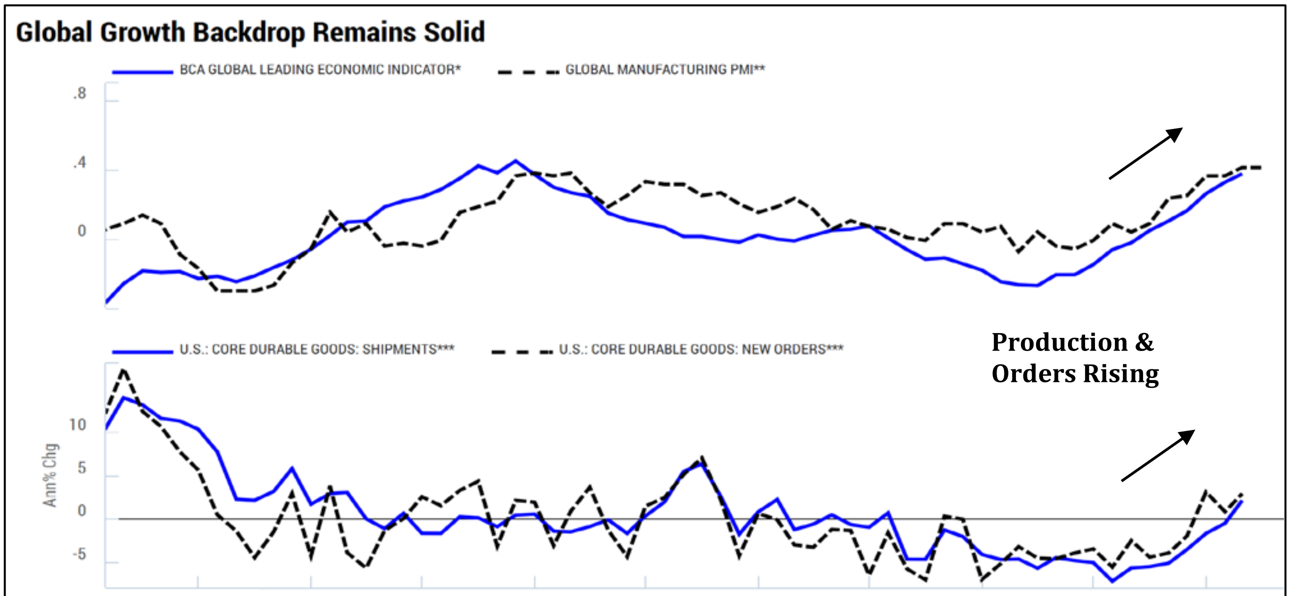
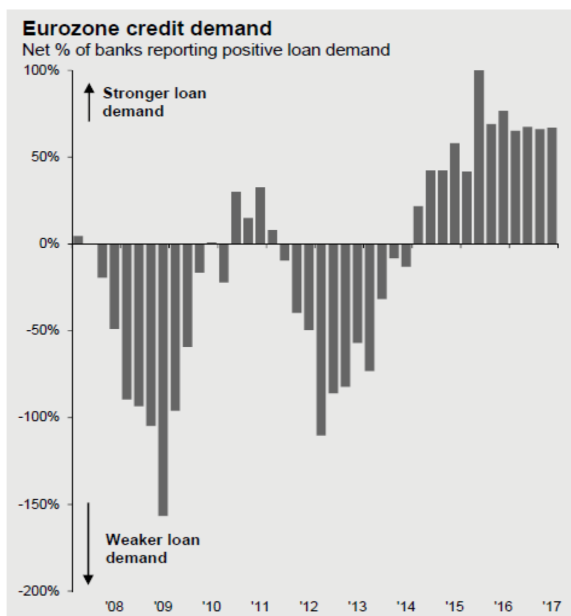
Economic Data Points to Growth



Source: BCA Research

While the economic expansion since the end of the Great Recession has been sluggish, the U.S. economy today is arguably in good shape. Consumer confidence and employment data have been particularly strong. Monetary policy remains stimulative, financial conditions are easy and forward-looking indicators don't indicate an economic downturn. Although the economic expansion will turn eight years old this quarter, that doesn't mean that a recession is imminent. Credit excesses that typically lead to economic downturns aren't in evidence. For now, our view remains that modest economic growth will continue, even without a boost from fiscal stimulus.

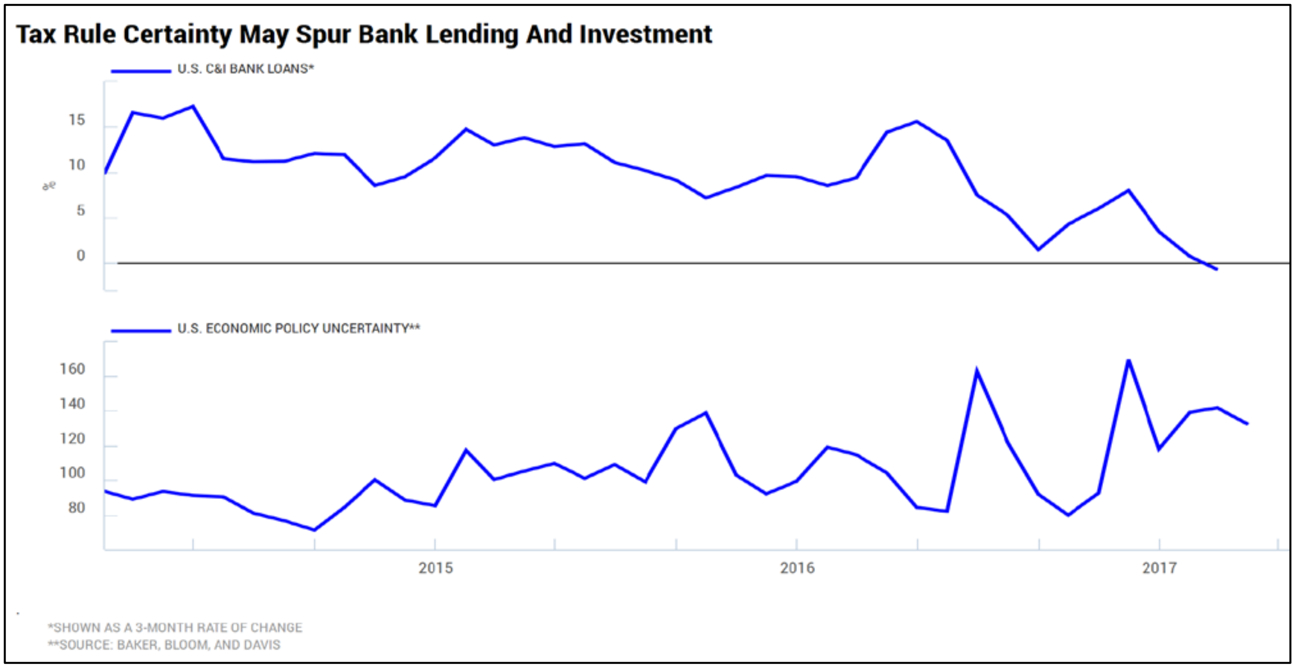
International Stock Outperformance? We continue to think international stocks can close some of the valuation gap with U.S. stocks. Europe, in particular benefits from lower valuation, high cyclical membership in its stock markets and a still ultra-loose monetary policy. Eurozone economic data have been strong so far this year. The PMIs for manufacturing and services pulled back a bit in March, but remain at levels consistent with above-trend growth. In addition, private-sector credit growth has accelerated to the fastest pace since the 2008-09 financial crisis (chart at right).



Source: J.P. Morgan

Although there is a lot of good news, capital expenditure and lending trends still lag expectations. It will be important to see progress on these trends, but we think the disappointments to date are explainable. In short, businesses may be waiting to ramp up their spending until they know the outcome of tax reform.

The chart below plots the 3-month annualized rate of change in commercial & industrial (C&I) loans, along with the U.S. Economic Policy Uncertainty Index. If uncertainty has been driven by fears about the shape of tax reform and deregulation, then the question is when and how much businesses will invest, not whether they will at all. If true, this suggests that weak bank lending and growth in capex has been delayed, not derailed.



Growth has also resumed in the emerging markets, although China's corporate debt expansion continues to worry investors. We do think China has a problem, but expect the government to use its considerable resources to prevent a hard landing.

Another note on China: genuine credit bubbles tend to happen during periods of euphoria. U.S., Spanish, and Irish banks all traded at lofty multiples to book value on the eve of the 2008 financial crisis. That's not the case for Chinese banks, which are one of the most feared sectors in the global equity market.

Alternative Investments Investors' success in alternatives requires excellent manager selection and tolerance for significant illiquidity, along with careful attention paid to fees and the sustainable advantage of the manager. Even in light of these caveats, we believe alternative investments can play an important role, both offensively (return-seeking) and defensively (less or uncorrelated to traditional stock and bond investments). While fundraising in private equity and private real estate is high, certain niche opportunities remain very attractive. In private debt, we still see opportunities in the growing alternative financing market as traditional bank finance continues to be replaced and assets coming out of crisis-era securitizations need new lending.

If you have any questions, please do not hesitate to contact us.

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