2017 Roundtable Contributors

Panelists

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Geoff: I want to first thank the panelists for taking time out of your busy schedules to try and make sense of a very difficult time for portfolio managers and investors. First off, the U.S. Economy seems to be firing on all cylinders, here late in 2017. Are there areas of the global economy that are giving you cause for concern despite the appreciation? Steve, let's start with your insights.

STEVE: The UK concerns me, especially as I expect more of a "hard Brexit". The country has a fairly significant current account deficit, elevated levels of government debt relative to GDP, sluggish productivity and rising inflation due to currency depreciation. Monetary policy is stuck near the zero lower bound, with the Bank of England's last action a rate cut to 25bps in August 2016. Consumption appears to be slowing, punctuated by a big year over year drop in auto registrations. House prices increases have slowed which is likely partially responsible for weak consumer confidence readings latterly.

BRIAN: Steve, I can appreciate your thoughts on the UK. The Eurozone is posting economic data that is more promising than US data and growth in Asia looks strong as well. There are no macro factors on the global economy that jump out as concerning but policy concerns in three different areas are cause for concern. First, India has seen growth estimates cut as the 2nd largest emerging market economy struggles to find its footing after the demonetization of large bills and a new GST tax as high as 28%. Even with the policy headwinds the Indian economy is growing but Modi may learn that the cost of reform can be higher than anticipated. The UK economy would be the next concern as it appears they are headed for a "hard Brexit". The banking industry in The City is vulnerable as no major banks want to choose between working in the UK alone versus across Europe. Spending has slowed dramatically even though employment is strong, the BoE will likely have to intervene more than anticipated and if they are slow to respond a recession is likely. Last, Spain being forced to dismiss the Catalan independence vote is going to wreak havoc in the most prosperous part of the Spanish economy likely derailing the recent growth.

JOHN: Well, as a global economy, we continue to build up debt, we continue to build up unfunded liabilities that do not seem to create immediate concerns by central bankers. That's kind of the problem in a world where we don't seem to act unless there is an immediate crisis.

Geoff: Thanks, John. Your readers are all well aware of those concerns. Thanks for sharing that with our readers. Geopolitical events heated up this year, especially the escalation with N. Korea, but did nothing to derail the markets from making new highs. Are you concerned that could change any time soon with the markets focused on geopolitical risk? Brian, what do you think?

BRIAN: It certainly appears to me that the next recession and bear market for global stocks will come about as a result of an exogenous geopolitical event. The Catalan independence in Spain is a reminder that events can unfold quickly. I have been surprised that rising tensions on the Korean Peninsula have been largely ignored by the markets thus far. The nature of terrorism has shifted to more lone wolf acts that the markets have shrugged off but will continue to lead to a rise in nationalism. Changing policies do constitute a future threat in my opinion.

Geoff: Steve, your firm does research on Asian markets. You bring a unique perspective.

STEVE: I think clearly the US is pivoting toward Asia and engaging more seriously. China's rise has created a scenario described by Graham Allison in his new book *Destined for War* as a "Thucydides Trap". In history there have been 16 identifiable situations of a rising power challenging and eventually eclipsing a status quo power. The first such situation was the Peloponnesian War in 431-404 BC where a rising Athens dislodged Sparta—the status quo power of the day. Of these 16, 12 of them eventually led to war. I would view the competition the US and China are in through this lens.

"China's rise has created a scenario described by Graham Allison in his new book Destined for War as a "Thucydides Trap".

Geoff: Thanks, Steve. I will be sure to pick up a copy of Destined for War. Sounds intriguing and timely. Looking to 2018, how important are tax cuts to your view of GDP growth in the US?

JOHN: I think if we don't have tax cuts of some kind, the markets are going to be pretty upset and they'll react. And Not Positively!

STEVE: Not really. Depending on how the fiscal package is structured, it could show positive supply-side effects that would likely be felt in the next expansion more than the current one. If "tax reform" devolves simply to "tax cuts" then I actually think this is a market negative. It would stimulate demand in the short-term causing the Federal Reserve to raise rates more than they otherwise would, possibly overshooting and causing a recession.

BRIAN: I think tax cuts are very important to consumer confidence right now as the Trump administration needs some legislative victories to justify people's positive outlook. If confidence begins to wane, GDP is likely to slip back into the 1% - 1.5% range we were stuck in over the last decade. A lower repatriation tax could increase much needed capex spending and boost GDP by .5% in 2018. Add in the benefits of a lowered corporate tax rate and simplified personal income taxes and growth could see a combined 1% bump from current levels. The bigger challenge will be convincing the market tax reform will remain budget neutral and not lead to significantly higher debt that becomes a future drag on growth.

Geoff: We have three unique perspectives based somewhat on semantics. How expansive do you think tax reform will be?

BRIAN: This reminds me of the advice I gave my kids when teaching them how to play golf, "swing hard in case you hit it." I think Trump and Republicans feel pressure to accomplish something other than a marginal tax rate reduction around the edges. Trump and his economic team seem confident they can deliver 3% growth which will require very expansive reform. I am not holding my breath that it will occur.

STEVE: This is hard to know. The one element that I wish would be included in the discussion is entitlement reform. This is the elephant in the room with respect to government finances for the foreseeable future. Not talking about entitlement reform and focusing on cutting taxes is short sighted.

"I think if we don't have tax cuts of some kind, the markets are going to be pretty upset and they'll react. And Not Positively! "

JOHN: You know that is something they (Congress) don't know, nobody knows. They're still trying to figure this out. It's really pretty depressing in one sense. These are supposed to be the guys (Republican Party) on my team, ok. And they're the gang that can't shoot straight. What we have is two factions in the Republican Party, the ones that wants tax cuts and the ones that want to balance the budget. I would like tax reform but we're just not going to get that. There doesn't seem to be any movement other than maybe taking away state deductions, state/local tax deductions to help balance the budget if they get these tax cuts. I don't know how they are going to pay for them. This whole thing that "Tax cuts pay for themselves" and you know they go back and track the experience of John Kennedy and Ronald Reagan and while that's true, those were in completely different economic circumstances, completely different debt circumstances, completely different everything. While I don't disagree that tax cuts will be stimulative, all of a sudden now we're running multi-trillion-dollar or more deficits and that's problematic.

Geoff: John, that is really powerful insight. History will be the judge. Fed Chair Yellen's term ends on February 3, 2018 and consensus suggests Trump will appoint someone else. What are your views of the people on the short list to replace Yellen? What do you think, Steve?

STEVE: I don't have terribly strong views on who the next Fed president will be. People seem to have themselves worked into a narrative about how hawkish John Taylor would be. If I plug into my Bloomberg Taylor Rule function a zero-neutral real rate and a 4.5% NAIRU, I get a prescribed policy rate of 1.24%. That is exactly where we are today. It should also be noted that his model, using these same variables, would have called for a -4.5% rate in 2009-2010.

Geoff: Thanks for sharing that useful data. John?

JOHN: We're going to get a Trump Fed. There is no question about that. It depends on whether its Taylor or Jerome Powell. Evidentially Taylor impressed Trump when he talked to him, and you know Taylor is an impressive academic and he has the credentials…no question about it. If Trump wants a hardliner you're going to get John Taylor or Kevin Warsh. If he wants somebody that going to look more like Yellen we're going to get Jerome Powell.

Geoff: Brian, being with you in the office every day, I know you track the Fed very closely. What are you seeing?

BRIAN: I think Trump will try to appoint both Stanford economist John Taylor and current Fed Governor Jerome Powell as Chair and Vice-Chair, in that order. The markets appear to favor Powell believing he would maintain the accommodative status quo but I don't think Taylor would be as hawkish as some are speculating. I think the Fed has veered off course the last couple of decades and need to return to more of a pure data-driven decision making process. Taylor would bring more of a quantitative approach in contrast to the currents Fed's subjective interpretation of data and anticipation of what the future may hold in determining Fed policy.

Geoff: This is a great discussion. Let's follow it up. If Yellen and Vice-Chair Fischer both retire when their leadership roles are completed, it is likely that Trump appointees will be the majority of the Fed before the end of next year. How do you see this impacting Fed policy?

BRIAN: I would be wary of the law of unintended consequences when attempting radical changes like eliminating $100 bills. The argument has been made about how that would eliminate much of the black market economy and "under the table" arrangements but ignores the reality that a lot of people hold cash for legitimate reasons. Power was out in Puerto Rico for days following the hurricane that hit there, banks were closed and ATM's did not work, requiring a cash hoard to purchase anything. The threat of a weaponized EMP that impacts the electric grid is another reason why large amounts of cash could be needed. The example of India suggests such a policy may have a far greater negative impact on growth than expected.

STEVE: I just finished Ken Rogoff's new book, *The Curse of Cash*, where he lays out the logic to slowly phase out cash. One hundred dollar bills represent about 80% of the value of all US notes out there. By slowly removing high denomination notes, the Fed could begin laying the groundwork for the employ of negative interest rates. By removing high denomination notes, the public wouldn't have the ability to hoard cash, thereby thwarting the policy of negative rates. This may seem far-fetched, but I would think about like the introduction of the gold standard, the introduction of greenbacks in the Civil War, the Bretton Woods system and the eventual severing of the gold standard. With human progress and development comes new monetary arrangements that suit the times. The ability for the Fed to take rates as negative as the Taylor Rule would have suggested in 2009-2010 would likely have led to a greater economic revival faster. It is clear QE was a second best policy.

Geoff: Thanks, Steve. Another great book recommendation! I have some reading to do. Thank you. Moving on to the Markets, you have record low volatility in 2017 do think that the muted volatility carries over into 2018? Brian?

BRIAN: Anything is possible but it is not the likely scenario in my outlook. In September, the markets hit all-time highs while volatility was at a 24-year low. This past year will likely remain in the record books as the lowest volatility for many years to come. That volatility was absent while the Fed both continued its tightening cycle and began the process of shrinking its balance sheet means nothing is impossible. I do not expect high levels of volatility but do not think we can hover around 10 on the VIX for the next 12 months. Steve, I have always been impressed by how you track so many different data points. I am curious to hear your thoughts.

STEVE: In my work, the main culprit for low equity volatility (VIX) and bond volatility (MOVE) is low and stable oil prices. Volatility is well correlated to the term premium in the US Treasury market. The fall in oil from over $100/barrel in 2013 to $50 today has exerted downward pressure on the term premium and in turn volatility. If oil prices begin to move up into 2018 on the back of inventory normalization, then I suspect the term premium begins to rise and, in turn, volatility.

Geoff: An interesting take on oil's relationship to volatility. John, what are your thoughts on complacency in the market.

JOHN: Yes. I think that volatility is one of those things that carries over until it doesn't and when it doesn't it's going to be really disruptive. I am pretty distressed actually by the lack of volatility in the markets. There's been no down turn. This is the longest period of continued highs and continued improvements that we've ever seen in history. I just don't see how that complacency is a good thing.

Geoff: Thanks John. ETF flows set records in 2017 and have become the investment du jour. If volatility were to increase in 2018 are there liquidity risks if inflows turn into outflows? Brian, Peak has a strong national presence for leadership in ETF trading and implementation. What is your take?

BRIAN: A recent WSJ article highlighted how millennial investors are flocking to ETF's as their investment of choice. I expect this trend to only increase going forward as assets flow out of mutual funds and into ETF's. Liquidity risks would be limited, in my opinion, to the esoteric indices that were designed mainly for the creation of ETF products. There are ETF's based on assets classes that simply do not have sufficient liquidity to justify trading on a daily basis. These products already have narrow liquidity doors that will become even more narrow when everyone rushes for the exits. The vast majority of ETF assets should never have liquidity concerns regardless of where volatility goes.

STEVE: Corporations, in the form of stock buybacks, have been the principal source of demand for equities, and they are not swayed by the VIX. If monetary policy tightening measures gain tractions and the price of credit goes up, there will likely be fewer debt-financed stock buybacks.

Geoff: To that same end, market leadership has been completely elusive with the equity markets hitting new highs. Do you have thoughts on where you see market leadership emerging and what's going to drive it?

BRIAN: Market leadership is elusive primarily because it is increasingly difficult to find compelling value in any sector or cap weighting. At the risk of disagreeing with the panel sage (Mauldin), I think the tsunami of assets flowing into passive investments is more of symptom than a cause. Historically investors would alter their allocation between stocks and bonds depending on market conditions but since the Fed's policy of financial repression started investors have had the option of stocks or stocks. The lack of attractive alternatives to equities is the driving force behind the record level of passive investing inflows in my view.

"At the risk of disagreeing with the panel sage (Mauldin), I think the tsunami of assets flowing into passive investments is more of symptom than a cause."

JOHN: You know, this market has me so confused. Honestly, I think that trying to make predictions about market leadership in a market that just keeps relentlessly wanting to go up. I think where the leadership is actually coming from is the move into passive investments. I mean they're buying these big across the board indexes. And not only that you get the bank of Switzerland now owns something like 4% or more of the S&P 500, the Bank of Japan is buying the S&P 500. And they're buying products that track the indexes, they're not stock picking they're just saying "We want the whole thing". If there's any leadership out there its coming from the move to passive investing.

STEVE: I see the US Dollar beginning a bear market as we are late in the economic cycle, the trade deficit is widening (especially the non-oil component, which is in greater deficit than 2008) and national savings are falling. In a US Dollar bear market like 2002-2008, sectors like energy and materials are leadership while sectors like technology and health care underperform. A US Dollar bear market will likely de-FANG the darlings of the market.

Geoff: Tell us about your forward outlook for the equity markets.

JOHN: You know one of the good things about the way that I'm running my models right now, is that I don't have to make a call. My models make the call for me. In this case, part of my model is Peak Capital. You guys have a risk analysis system/ distribution system that's different from what Tectonics does which is an endowment model, which is different than the multi-player game theory which is different from the momentum model that the other two managers use.

So, the combined part of that ends up kind of making my call for me. Now if you look at what's been happening to that we've seen some risk start coming off the table lately. But the irony is it doesn't seem to have hurt our performance at all even in an up market like we've seen.

Geoff: Thanks, John. It is useful to hear practical application of how to address current and future markets. I know the premise behind Mauldin Solutions is to diversify across strategies rather than asset classes. For readers that would like to learn more, they can go to www.mauldinsolutions.com. The team at Peak Capital can also assist in any way providing direction on access to Mauldin Solutions. Brian, how about you?

BRIAN: Newton's 1st law of motion states that a body in motion will remain in motion until an opposite force is exerted. This describes uptrend in the equity market today. The issue is when does that opposite force appear and what is the cause? If large enough tax reform is passed the next recession could be more than a year away meaning stocks likely continue their trend higher. Higher GDP growth will put pressure on the Fed to keep their foot on the brake (tightening) likely resulting in higher fixed income volatility than equity volatility. It looks as though another year of being overweight stocks with increased international exposure will be rewarded.

STEVE: I think there is already a fairly significant rotation underway in the global equity markets. For the last handful of years, the US equity market has outperformed the world; developed equities have outperformed emerging markets; small caps have outperformed large; resources sectors globally have underperformed while technology has outperformed. I see the exact opposite of that scenario playing out for the next few years, where foreign markets outperform the US, large caps outperform, emerging markets and resource sectors outperform.

> "I have this "perfect trinity" that I try to find with stocks."

Geoff: There is a bull market somewhere. Where are some areas you see opportunity that the market may be overlooking today?

STEVE: I have this "perfect trinity" that I try to find with stocks. I try to find stocks that are net down 7-9 years, have slashed capital expenditures and whose stocks are cheap and trade dull, i.e. low point spread and volume. The resource sector, specifically mining and oil-related companies fit that template for me right now.

Geoff: Again, great practical information for our readers.

BRIAN: Natural resources would top my list along with energy services. Valuations are attractive in these sectors and could rise sharply if global growth estimates remain on track. Companies that provide construction and engineering services, particularly for heavy infrastructure, should see strong earnings growth but stock prices reflect the anticipated growth.

JOHN: I think globally there is a lot of opportunity out there right now, and we're seeing a lot of markets globally pick up. So yes, there's always opportunity somewhere, the question is "Who's doing the picking" and right now the people seem to want what they think of as the safety of indexes. I think that will end up proving to be an elusive shelter.

Geoff: Shifting our focus over to bonds, there's so much uncertainty on the direction of yields going forwards. What are your thoughts on rates going up? In the past you've talked about the potential for negative rates in the United States. What's your outlook for fixed income?

BRIAN: My concern is that the Fed (and market) is underestimating the impact that shrinking the balance sheet will have on liquidity. The fixed income markets really need relief from the unintended consequences of Dodd-Frank that reduced liquidity and market making functions. We have been contrarian by favoring long durations in our fixed income allocations but is see shortening duration going into 2018 and maintaining slight overweight to high yield.

STEVE: I think you are going to see a fairly significant changing of the components inside US Treasuries. I would anticipate that term premiums and breakeven inflation begins to creep up with rising oil prices. But, at expectations embedded in bonds. TIPS would be

preferred to nominal treasuries in such a scenario. Among high-yield bonds, spreads are widest for the energy sector (OAS 485bps) and rising oil prices will be a tailwind for these credits.

JOHN: My thoughts right now would be that we're seeing the yield curve flattening a little bit. The long end is not rising along with the short end as the FED is pushing rates up. That's a little troubling seeing a yield curve flattening, and question then becomes how much are they going to actually move these rates. How much is the new chairman going to keep it rising. I think it's a full gone conclusion they'll move them up in December and its possible that before Yellen leaves they'll move them up one more time. The natural level of rates on the low end is LOW, not far from where we are today. Maybe two more rate hikes unless, for some reason, the economy really starts cranking up. Which doesn't seem to be an issue today. Short term rates may be low for a long time.

Geoff: Last question that is on everyone's mind, what risks or fears are on your radar that the average investor is just simply overlooking or not aware of? Steve?

STEVE: Whether it is a risk or opportunity I guess depends on your perspective, but I think the thing investors are completely unprepared for is a US dollar bear market. US Dollar bull and bear markets exert different "gravities" to various assets. US Dollar bear markets are not the time when speculative "growth" companies with negative cash flow and exorbitant valuations outperform.

JOHN: The extraordinary level of complacency in the market. I've said this before but it's really true. There is a bull market in complacency. I continue to be amazed at how people don't see any risk. They just continue to put money into passive investments and I guess to them that's what's worked. They keep saying "Well why should I pay these fees and why should I do all of this?" but it's that complacency that is telling them to do that; that is worrisome to me. They're just not seeing any risk. And you and I both know risk shows up on the days you don't want it to and it shows up rather rapidly. Bull Markets happen over time, risk markets happen quickly.

"There is a bull market in complacency."

Geoff: Time tested wisdom. Brian, what is the average investor just not seeing?

BRIAN: Disappointment risk that Congress continues its ineptitude remains a concern but investors are fickle making it virtually impossible to know when they would give up and turn bearish. Even a modest increase in yields could push many state and local issuers to the verge of insolvency requiring drastic reductions in services and spending. It is not a high probability event in 2018 but will prove to be extremely disruptive when investors are forced to confront funding gaps for budgets and pensions.

Geoff: Thank you, to all the panelists. The knowledge and experience shared here can only be the product of the grey hair gained through experience of both good times and the raging bear. We are grateful to each of you. Again, thank you.

Roundtable Contributor Bios

Brian Lockhart, CFP®

Brian is the founder and Chief Investment Officer of Peak Capital Management, LLC (PCM). With over 20 years of portfolio management experience, he serves as the co-portfolio manager of PCM's suite of strategies. Brian directs the company's tactical allocation of PCM's unique investment models and has been crafting ETF strategies for nearly a decade, making PCM an early adopter of ETFs. Brian has been featured in multiple media outlets including Barron's, Forbes, Fortune and Business Week. An active conference speaker, Brian communicates on topics ranging from portfolio and risk management to alternative investments. A graduate of Polytechnic State University in California, Brian received his Bachelor of Science degree in Business Administration with a concentration in Financial Management. He and his wife, Cindy, have been married for over 25 years and love living in Colorado where they raised their two children, Caleb and Jennifer.

John Mauldin

Each week, hundreds of thousands of investors and financial professionals around the globe turn to John Mauldin to better understand Wall Street, global markets, and the drivers of the world economy. And for good reason. John is a noted financial expert, a New York Times best-selling author, a pioneering online commentator, and the publisher of one of the first publications to provide investors with free, unbiased information and guidance—Thoughts from the Frontline—one of the most widely read investment newsletters in the world.

John Mauldin is the Chairman of Mauldin Economics which publishes a growing number of investing resources, including both free and paid publications aimed at helping investors do better in today's challenging economy. For more information on these publications go to www.mauldineconomics.com.

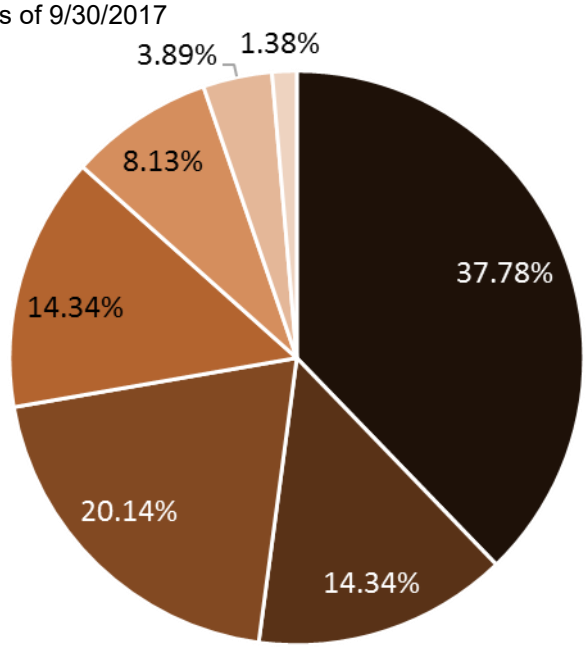
In addition, John is the host of the Strategic Investment Conference—an annual event for investors that draws a faculty of some of the most respected investment and economic luminaries in the world. He is a frequent speaker at conferences around the world and consults with a number of private firms. He is also a sought-after contributor to numerous financial publications, as well as a regular guest on TV and radio.

Steven Vannelli, CFA - Founder, CEO and CIO, Knowledge Leaders Capital

Steven Vannelli is founder, CEO and Chief Investment Officer. He oversees investment strategy, asset allocation and security selection for the Knowledge Leaders Investment Strategy. Steve leads development on the firm's analysis of intangible capital, studying how it affects corporate profitability and wealth creation. His work is the core of the firm's investment methodology, which is based on a novel approach to accounting for intangible capital. Steve has been an equity analyst and portfolio manager for more than 20 years. He also serves on Peak Capital Management's Investment Committee. Previously, he served for 10 years at Denver-based money management firm Alexander Capital, most recently as Head of Equities. Steve holds a bachelor's degree in finance from the University of Denver and is a CFA charterholder.

Income

As of 9/30/2017

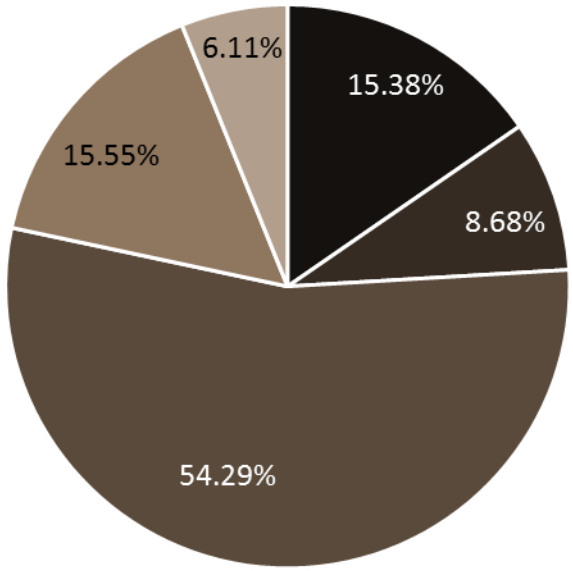


- Mortgage Backed Bonds
- Investment Grade Credit
- High Yield Bonds
- Preferred Stocks
- Us Dividend Stocks
- REITs
- Short Treasury Hedge

*Weights might not sum to 100 due to rounding

Balanced Income

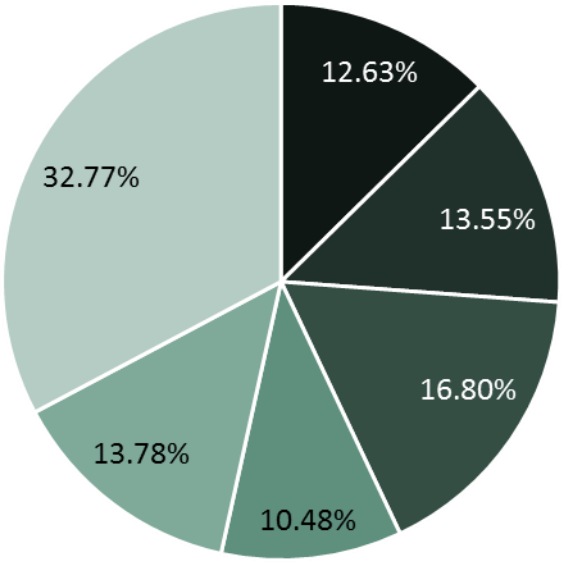
As of 9/30/2017



- U.S. Dividend
- U.S. REITs
- High Yield
- International Dividend
- U.S. Treasury

U.S. Growth

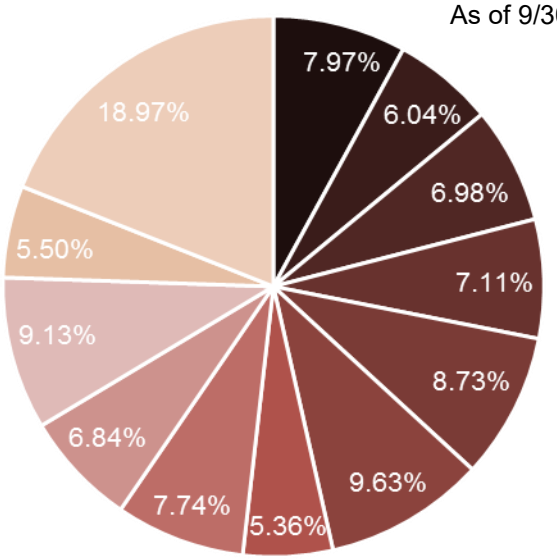
As of 9/30/2017



- Momentum Stocks
- Value Stocks
- Low Volatility Stocks
- Small Cap Stocks
- High Quality Stocks
- U.S. Treasury

Global Growth

As of 9/30/2017



- US Value Stocks
- US Small Cap Stocks
- US Momentum Stocks
- US High Quality Stocks
- US Low Volatility Stocks
- Developed Market Pacific
- Developed Market Europe
- Emerging Markets Europe
- Emerging Markets Pacific
- Emerging Markets Latin America
- Emerging Markets Mid East/Africa
- US Long Term Treasuries

*Weights might not sum to 100 due to rounding

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Acronyms

Non-accelerating inflation rate (NAIRU)

Electromagnetic pulse (EMP)

Quantative Easing (QE)

Chicago Board of Option Volatility Index (VIX)

Chicago Board Options Exchange Volatility Index (MOVE)