

November 2016

Our global benchmark was up 0.9% in November, with U.S. stocks, especially Small Cap, outperforming subsequent to Trump's victory, the near term consequences of which we covered in November 9th's *The Triumph of Populism: Our Initial Thoughts* and in the 13th's *Brexit, now Trump: Why a System Based Approach is Better*. Today's Jobs report, with the unemployment rate dropping to 4.6%, insured that the Fed will raise interest rates on the 14th. Meanwhile, the carnage in Bonds continues, with this from the front page of today's WSJ:

## Bond Market Slide Intensifies

Rise in yields since July has pushed the 10-year Treasury note up by more than 1 percentage point

By [SAM GOLDFARB](#), [MATT WIRZ](#) and [AARON KURILOFF](#)

Updated Dec. 2, 2016

The worst bond rout in three years deepened Thursday, hammering debt issued in emerging markets and many U.S. states and cities ....

The yield on the 10-year Treasury note rose to a 17-month high, at 2.444% ....

The surge since July has pushed the 10-year yield up by more than 1 percentage point, only the fourth time it has risen so much so fast since 2009. Rising rates can reflect optimism about economic prospects, yet over time they can also slow growth by making borrowing more expensive for consumers and businesses.

Bonds issued by emerging-market countries like Mexico and Turkey have been hit hard in recent weeks, reflecting fears that a strong dollar and the prospect of slower global trade under a Donald Trump administration will hurt companies there. U.S. municipal bond prices also have declined amid concerns that tax cuts could erode the value of the debt's tax breaks.

American companies are emerging as relative winners in the selloff. Yields are rising off such a low base that few economists or traders are concerned for now about ripple effects through the economy.

The cross currents are the latest sign that Wall Street is placing a broad-ranging bet on an accelerating U.S. recovery. Expectations of higher growth and inflation have sent the Dow Jones Industrial Average to repeated records since Mr. Trump's election Nov. 8, while fueling gains in the U.S. dollar. On Thursday, the Dow industrials rose 68.35 points, or 0.4%, to 19191.93, its 18th record close this year.

Still, higher rates could eventually start weighing on stocks and the economy as companies begin to borrow less for expansion and consumers spend less on homes and other purchases.

"If rates were to move up dramatically higher, it will start to influence risk assets and growth and certainly housing demand," said Rick Rieder, chief investment officer of global fixed income at BlackRock Inc., the world's largest money manager by assets. But "we certainly are not at that level today." ...

Mr. Rieder said rising yields will likely be a positive for the economy as long as the increases remain modest, because higher long-term rates boost bank profits and tend to be associated with higher levels of lending, which often feeds through to stronger economic growth.

## Past, Prologue

Treasury yields have risen sharply during the fall bond selloff, but other similar episodes in the postcrisis period ended in reversals.

### U.S. Treasury 10-year yields



Source: Ryan ALM

THE WALL STREET JOURNAL.

That process is “helping a tremendous amount of the financial system,” he said.

The selloff in Treasuries has hit emerging markets hardest. Those bonds had only recently began rebounding from a slump spanning more than a year, caused by a decline in commodity markets.

The J.P. Morgan Emerging Markets Bond Global Index Diversified had gained about 14% through September but lost 1.2% in October and 4.1% in November. Investors pulled \$1.4 billion out of emerging-market bond mutual funds in November, the first material outflow since February, according to data from [Thomson Reuters](#) Corp.’s Lipper unit. ...

The election also sparked a rout in debt sold by U.S. state and local governments, pushing total returns for November in the S&P Municipal Bond Index to its worst month since September 2008, according to S&P Dow Jones Indices. The iShares National Muni Bond exchange-traded fund has lost 4.3% since Election Day.

The selling reflects concerns that a Republican-led Congress and White House will cut taxes, reducing the appeal of the tax-free interest payments that make municipal debt attractive to individual investors, some analysts said. Other concerns include the possibility that Mr. Trump’s proposed increase in infrastructure spending will flood the market with new bonds, pressuring prices. ...

The sharp rise in yields reminds some investors of 2013, when worries that the Federal Reserve would end its bond-buying program rattled the bond market. But so far, the outflows that characterized the “taper tantrum”

have yet to materialize. U.S. bond mutual funds that target Treasury securities have had 11 consecutive weeks of outflows through Nov. 23. But investors pulled just \$175 million over that span, according to Lipper. In one week in November 2013, outflows exceeded \$300 million.

“The average retail investor will be slow to change direction in their mutual fund portfolios,” said Tom Roseen, head of research services at Lipper.

We concur with the following analysis from Koesterich:

## Yes, the bond selloff can continue

Written by [Russ Koesterich, CFA](#) Head of Asset Allocation for BlackRock’s Global Allocation Team

November 28, 2016

The unexpected outcome and potential consequences of the U.S. presidential election continue to shake financial markets. Nowhere is this more so than the U.S. bond market.

Yields on the 10-year Treasury are up 50 basis points (bps, or 0.50%) since the election and nearly (now over) 100 bps from the July lows, as bonds sold off. This marks the fastest rise since the so-called “taper tantrum” in 2013, when expectations of an increase in interest rates by the Federal Reserve triggered a bond selloff.

After such a sharp selloff in bonds, we could arguably see markets settle down and prices stabilize for a bit. But over the long term, I would argue the selloff in bonds—and corresponding rise in yields—will continue for two basic reasons:

### **Higher nominal GDP growth going forward**

Whether the new administration’s policies lead to faster economic real growth(after inflation) is an open question. But they are almost certain to lead to faster nominal growth, which includes inflation. This is important because over the long term it is nominal growth that drives rates. Going back to 1962, nominal growth has explained roughly 35% of the variation in U.S. 10-year Treasury yields (see the accompanying chart). Roughly speaking, 10-year yields increase 50 bps for every one percentage point increase in nominal growth.

Today, nominal growth is slightly under 3%. To put that number in perspective, prior to the 2008 financial crisis nominal growth averaged better than 7%, including during recessionary periods. A modest rebound back toward the upper end of the post-crisis range would thus suggest a rise in 10-year yields back to approximately 5%. While an increase that high is unlikely given structural headwinds (such as demographics and the deflationary impact of technology), it suggests yields still have further to rise.

### **More bonds to sell**

In recent years, bond prices have been supported by a dearth of bonds coupled with strong demand from institutional investors. Banks, insurance companies and pension funds will continue to need long-dated fixed income instruments, but supply is starting to grow.

## U.S. 10-year Treasury yield vs. nominal GDP



Source: Bloomberg, as of 11/18/2016.

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Both corporate and household debt are now rising at or near the fastest pace since the financial crisis. On the corporate side, the conservatism that marked most of the post-crisis environment has given way to a willingness to add to debt, often to fund buybacks and dividends. For U.S. households, although debt growth remains well below average, borrowing rose by 4.4% annualized in Q2, only the second time since the financial crisis that growth eclipsed 4%. And over the long term, federal borrowing is also likely to grow and deficits increase, absent entitlement reform. The Congressional Budget Office forecasts a baseline projection of an \$814 billion deficit by 2021; and that does not include the potential impact of a large tax cut.

To be clear, relative to the 60+ year average of around 6%, 10-year Treasury yields are still likely to remain low. Nevertheless, in an environment of heightened duration, or volatility, the backup in yields will still cause considerable pain, unfortunately. I would continue to advocate that investors should underweight (**avoid**) bonds and bond market proxies, such as utilities (**never touch**) and consumer staples. Instead, faster nominal growth suggests more reliance on value stocks (**Amen**), which tends to perform best when growth is improving.

After Brexit, and Trump, strike three for the experts came on the last day of the month, as reported in the lead story from Thursday's WSJ:

## Oil Surges on OPEC Deal to Cut Production

Cartel representatives agree to reduce output by 1.2 million barrels a day

By **BENOIT FAUCON** and **GEORGI KANTCHEV**

Updated Nov. 30, 2016

VIENNA—OPEC representatives reached a landmark deal to reduce oil output, propelling crude prices more than 8% after months of wrangling and market uncertainty about the ability of the once-mighty group to strike an agreement.

The Organization of the Petroleum Exporting Countries said Wednesday that it would cut production by 1.2 million barrels a day from 33.6 million barrels and said it expects producers from outside the group, including Russia, to join with additional cuts totaling 600,000 barrels a day.

The OPEC cuts were deeper than many analysts had expected, amounting to about 1% of global production. The 14-member group hopes the output cuts will help shrink a supply glut that has been fed in part by the U.S. shale boom, and has depressed oil prices for more than two years.

At the same time, the pact benefits the shale producers, giving them an incentive to ramp up production—a move that could potentially bring a halt to any oil-market rally.

Oil prices surged and shares of more than 50 U.S. exploration-and-production companies climbed more than 10% following the agreement.

Crude for January delivery climbed \$4.21, or 9.3%, to settle at \$49.44 a barrel, on the New York Mercantile Exchange. Brent crude, the global benchmark, gained \$4.09, or 8.8%, to \$50.47, on ICE Futures Europe. Both finished at a one-month high.

The biggest gainers in energy stocks were generally those operating in regions that have been uneconomical to drill for much of the past two years. The S&P 500's energy sector advanced 4.8%.

Still, questions remain about the long-term impact of the deal and the ability of the group to enforce the cuts. The group has a checkered history of complying with its own agreements, with countries often producing more than their agreed-upon share. ...

The Qatari oil minister said a committee of Algeria, Venezuela and Kuwait will monitor compliance with the agreement, though he didn't specify how noncompliance would be defined, deterred or punished.

For a cartel that had been declared all but dead, Wednesday's deal was a reminder of the power wielded by a group that controls a third of the world's crude. Almost exactly two years after it decided to let prices slip into a free fall, the group finally acted, pressured by low prices and domestic fiscal demands to overcome bitter divisions, including those between Iran and Saudi Arabia, the group's de-facto leader.

The member countries were faced with a "very deep" abyss of low oil prices, and that won out over politics, said Daniel Yergin, vice chairman of [IHS Markit](#) and a longtime oil-market watcher. "OPEC is back in business," Mr. Yergin said in an interview. "This will rank as one of their historic decisions."

Saudi Arabia and Iran, whose differences blocked a deal that aimed to freeze production earlier this year, made the deal possible by coming to a tortured compromise on production figures. Iran was allowed to increase its production by 90,000 barrels a day, a significant victory for the Islamic Republic as it tries to rebuild its economy after the end of Western sanctions.

But the deal allows both Iran and Saudi Arabia to claim a win, by pointing to different sets of numbers. Iran, using production figures generated by OPEC, can say it is raising output, while Saudi Arabia can point to the Islamic Republic's output figures and say that Iran is agreeing to a cut.

"It's a good day for the oil market, it's a good day for the oil industry," Saudi Arabian Energy Minister Khalid al-Falih said after the deal was reached.

He said the deal, in which the Saudis agreed to take on the highest burden of cuts at 486,000 barrels a day, "is not only what we wanted, but what the market wanted."

Saudi Arabia did succeed in wringing a rare concession from a non-OPEC member in Russia. Just after OPEC sealed the deal, Mr. Falih called Russian Energy Minister Alexander Novak and asked for confirmation of a production cut. Russia said it would move to cut 300,000 barrels a day.

Saudi Arabia's support for cuts was a reversal from a position it has held through most of the price rout, as it sought to keep output high and fight for market share around the world. As a low-cost producer, it said it could live with low prices, while higher-cost producers like the U.S. would be forced out.

But while U.S. production did decline, shale producers proved more resilient than many had expected. Harold Hamm, chairman of Continental Resources Inc. and an energy adviser to President-elect Donald Trump, said Wednesday that U.S. oil production will rise in the wake of OPEC's cut, although it may take more than a year to see it.

Mr. Hamm said producers, including Continental, will unlock some of the thousands of drilled wells in the U.S. that haven't been pumped yet. "With the 1.2 million-barrel-per-day-less production, certainly it will pull that overhanging inventory down pretty quickly," he said.

Saudi Arabia's support of a deal that will help the U.S. producers it believed would be killed off by the rout shows how badly the kingdom now needs oil prices to rise. Its government has embarked on a plan to diversify its economy that includes a proposal to list its state-owned energy giant, Saudi Arabian Oil Co., in 2018.

But income from oil sales still accounts for more than two-thirds of the country's budget revenue. Analysts estimate Saudi Arabia needs oil at about \$70 a barrel to break even this year, after the kingdom posted a record budget deficit of \$98 billion in 2015.

That isn't a price most analysts believe will be reached this year, as even with the production cuts and some demand growth, there is a substantial inventory of oil stored around the world.

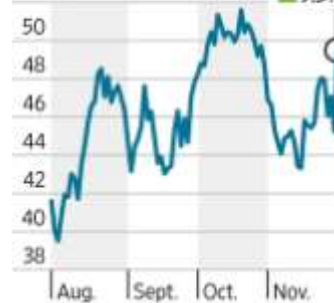
OPEC members have said they are targeting prices as high as \$55 to \$60 a barrel, a level that would boost petroleum-dependent economies badly damaged by two years of prices that were often below \$50 a barrel, and would provide some relief for energy companies that have been battered by the price drop.

## Pumped Up

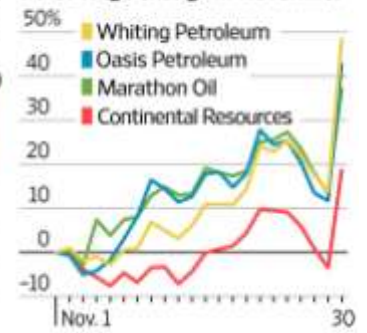
OPEC's agreement to cut production boosted the price of crude as well as some U.S. shale producers.

### Nymex crude

\$52 a barrel



### Percentage change in November



Sources: WSJ Market Data Group

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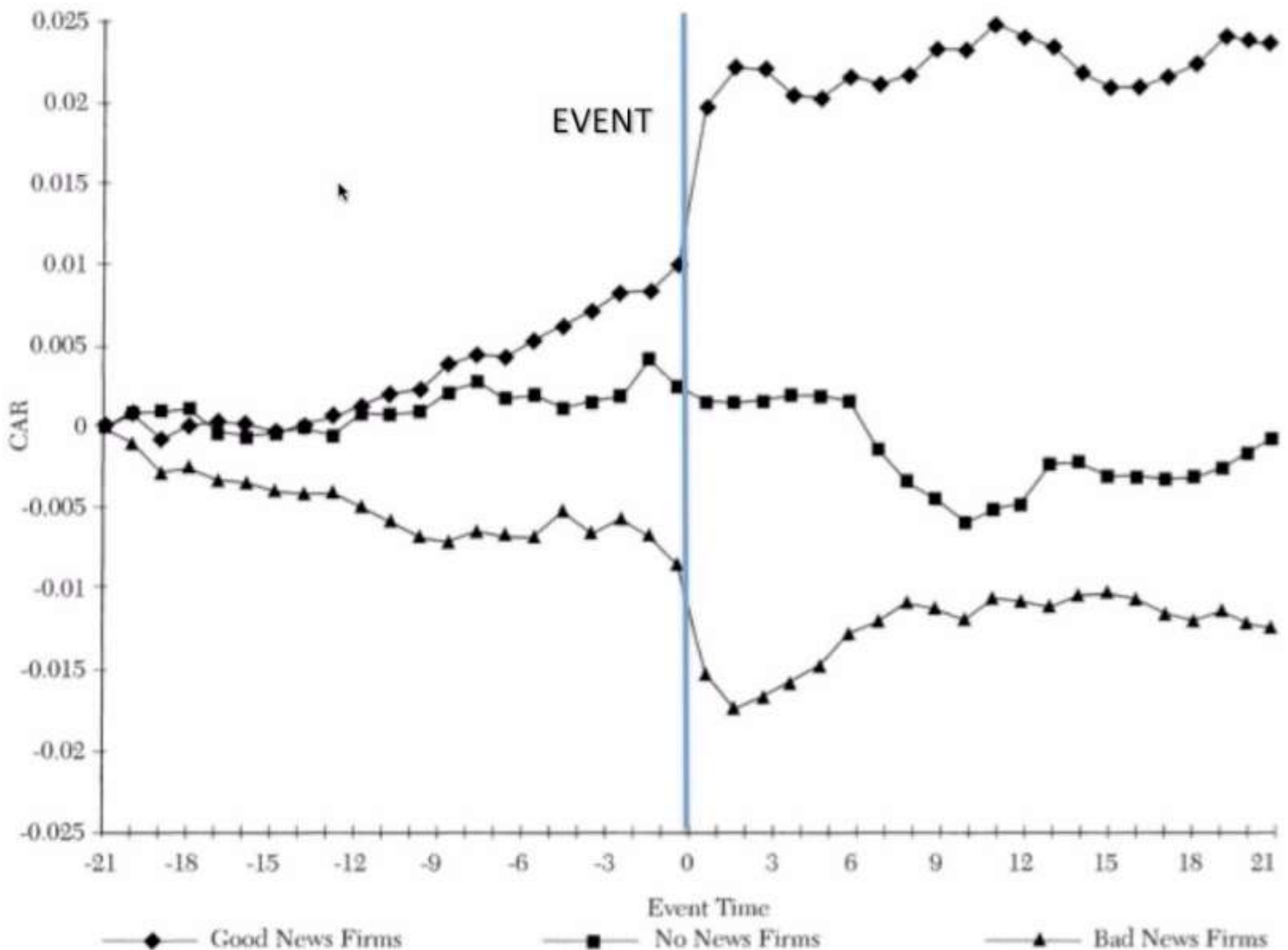
Such a level is widely viewed as a sweet spot for oil prices, because economists say it is still low enough to support economic growth.

## Positions

As shown below and detailed in our IVE System White Paper (posted on our website) stocks tend to overreact to Bad News:

*MacKinlay: Event Studies in Economics and Finance*

25



*Event studies in economics and finance*

AC MacKinlay - Journal of economic literature, 1997 - JSTOR

Waiting for the typical bounce has the added benefit of allowing us to see if the Insiders will buy again. In November we sold 3 client stocks where fundamentals appeared to have turned negative and the Insiders didn't step back up to the plate:

**ALLY** - Reported a Negative Earnings Surprise of 4.9% on October 26th, with the stock falling 3.8%. By 10/29 14 analysts had lowered, while only 1 had maintained, Earnings Estimates for the quarter ending 12/16.

For the quarter ending 3/17, 1 raised, 3 held and 7 lowered Estimates. While no analysts lowered their Recommendation, 9 held their Target Price, while 3 lowered it. We used a block trade on 11/16 to sell all positions @ 18.993. Quest Opportunity Fund, which will only sell once all HCM clients are out, sold its position later that day.



**UHC** - Reported a Negative Earnings Surprise of 45.2% on 11/1, with the stock down 24%. By 11/5 all 3 analysts had lowered their Earnings Estimates for 12/16, while 2 of them had also lowered for the quarter ending 3/17. One analyst lowered their Recommendation to Sell, while the remaining 3 maintained Buy ratings. Both the analysts that provided a Target Price lowered it. We sold all positions, again using a block trade, @ 13.73.





**FTR** - Reported a Negative Earnings Surprise of 60% on 11/1, with the stock down 13.7%. By 11/5 2 analysts had raised, 2 maintained and 5 lowered their Earnings Estimates for 12/16, while 2 maintained and 4 lowered for the quarter ending 3/17. One analyst lowered their Recommendation to Hold, often a PC Sell, resulting in 6 Buy and 6 Hold ratings. Target Price was left unchanged by 3 analysts, lowered by 6. We sold the position with a market order on 11/25 @ 3.6638.



**HEES** - is an excellent example of a stock we decide to Hold based on Managements' comments attributing the 7/28 Negative Earnings Surprise of 22.5%, with the stock down 4.9%, to weather. One analyst maintained, while 6 lowered their Earnings Estimates for the quarter ending 9/16. For 12/16, 1 raised, 2 held and 4 lowered Estimates. None of the 5 analysts (2B 3H) lowered their recommendation, 3 held and 1 lowered their Target Price.



Insiders bought again, although too late if we had decided to sell:

Participants	Relation	Transaction Type	Shares	Trade Price	Trade Date
BARBER BRADLEY W	Officer	Open Market Purchase	4,901	13.4400	11/01/2016
ARNOLD PAUL N	Director	Open Market Purchase	5,000	12.8200	11/01/2016
ENGQUIST JOHN M	Officer	Open Market Purchase	17,000	13.4000	11/01/2016
BARBER BRADLEY W	Officer	Open Market Purchase	6,626	14.2200	10/31/2016
ENGQUIST JOHN M	Officer	Open Market Purchase	17,000	14.0700	10/31/2016

**DDDIX** - With HCM's 1st Client retiring on December 1st, it was time to move her out of this OEF. While we still believe that following Activists is a Factor worth considering for clients focused on Capital Appreciation, its **Risk** ratio of **2.2** times that of the S&P 500 is too high for someone transitioning to Capital Preservation/Income. We added the S&P 500 (green line) to Morningstar's chart for comparison.

### 13D Activist Fund Class I DDDIX | ★★★

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Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV	1-Day Total Return	TTM Yield	Load	Total Assets	Expenses	Fee Level	Turnover	Status	Min. Inv.
\$ 17.41	↓ -0.23%	0.00%	None	\$ 246.2 mil	1.50%	High	122%	Open	\$ 1.0 mil
USD   NAV as of 16 Nov 2016   1-Day Return as of 16 Nov 2016		30-Day SEC Yield	Category		Investment Style				
		--	Mid-Cap Blend		Mid Growth				



**BIICX** - We used the funds made available by the sale of ALLY and DDDIX for HCM's 1st Client to buy her our favorite Income Fund, with a **Risk** ratio of **0.6**. Note that with a "2.0 mil Min. Inv." this OEF is effectively only open to Registered Investment Advisor clients. We have added the S&P 500 (green line) and AGG (yellow line) to Morningstar's chart for comparison. AGG (iShares Core US Aggregate Bond Fund) "is among the cheapest ways to anchor a portfolio with core fixed-income exposure. Its bogy, the Barclays U.S. Aggregate Bond Index, is the industry standard" and the benchmark we use.

# BlackRock Multi-Asset Income Portfolio Institutional Shares BIICX

★★★★★ | Bronze

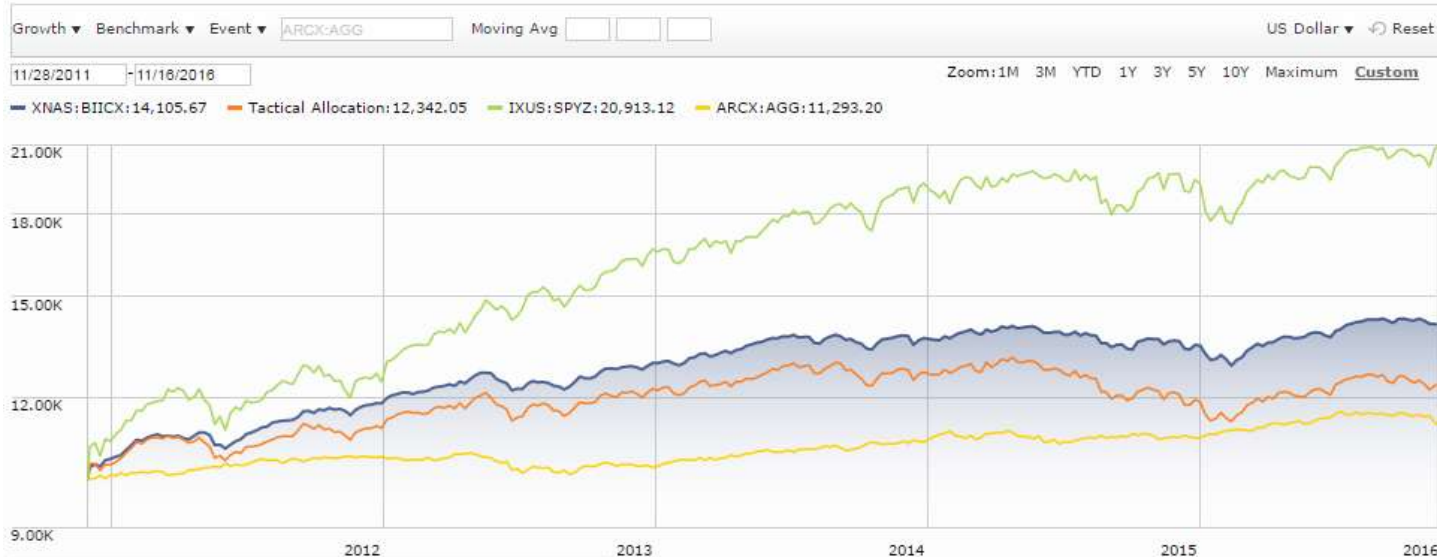
Morningstar  
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Fund Family Data | Add to Portfolio | Get E-mail Alerts | PDF Report | Data Question

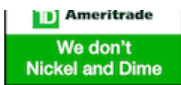
Quote | **Chart** | Fund Analysis | Performance | Ratings & Risk | Management | Stewardship | Portfolio | Expense | Tax | Purchase | Filings

NAV \$10.57 | 1-Day Total Return ↓ -0.18%  
 TTM Yield 4.72% | Load None | Total Assets \$ 13.7 bil | Expenses 0.55% | Fee Level Low | Turnover 82% | Status Open | Min. Inv. \$ 2.0 mil

USD | NAV as of 16 Nov 2016 | 1-Day Return as of 16 Nov 2016  
 30-Day SEC Yield 4.39% | Category Tactical Allocation | Investment Style Large Value | Credit Quality/Interest Rate Sensitivity Low/Limited



**IMOM** - This is the first time we bought Alpha Architect's International Momentum ETF for a client. It took 4 days (11/16, 17, 21 & 22) to fill, so liquidity remains a problem. We have added IVAL (orange line), Alpha Architect's International Value ETF, to Morningstar's chart. IVAL was already held by this and other clients. As we detail on our website, Value and Momentum are 2 Factors that academic research has found to be synergistic: "As both Value and Momentum have withstood the rigors of academic scrutiny, why not combine the two into a kind of super factor? Alpha Architects has studied this strategy, and found that while both value and momentum belong in a portfolio, they work best separately, not as a single factor. "The evidence suggests that a value and momentum system, which combines both pure value and pure momentum into a single portfolio, may prevent a value-only investor or a momentum-only investor from suffering through extended, long-term stretches of poor performance."



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**Last Price**      **Day Change**  
**\$23.23**      **↑0.05** | **0.22%**

**NAV**      **Open Price**      **Day Range**      **52-Week Range**      **12-Mo. Yield**      **Total Assets**      **Expenses**  
 23.24      23.24      23.23-23.30      21.20-26.81      —      18.59 mil USD      0.79%

As of Wed 11/16/2016 4:10 PM EST | USD

**Intraday Indicative Value**  
**\$23.25**      **↓-0.02** | **-0.10%**

**Prem/Discount**      **Volume**      **Avg Vol.**      **SEC Yield%**      **Bid/Ask/Spread**      **Category**  
 -0.10%      3719      6,283      0.88      11.61/ 33.66/ 97.42%      Foreign Large Blend

As of Wed 11/16/2016 4:29 PM EST | USD



## A Current Client

With the proliferation of Smart Beta Funds over the last several years, the roster of Funds we are currently using has changed. Last month we shared an example of the Initial and Goal portfolios for a client seeking Capital Appreciation, with a Risk Profile that obviates the Maximum Drawdown concern. This is the Goal portfolio for

%	Symbol	Type	Description	Factors (1)	Dist. (2)	Risk (3)
20	QMNIX	OEF	Global Long/Short Equity-Lg Blend	V, M, Q	2.4%	A 0
20	BIICX	OEF	Tactical Allocation		4.7%	M 0.6
40	IVE System Picks & RFY		Domestic	I, V, E	4.8%	1.4
10	IVAL	ETF	Foreign Lg Value	V, Q	2.1%	Q 1.3
10	OBIOX	OEF	Foreign Small/Mid Growth	S, M, Q	0.2%	A 1.3
<b>Weighted Average:</b>					<b>3.6%</b>	<b>0.9</b>

### Notes

- 1 V=Value, M=Momentum, Q=Quality, I=Insiders, E=Earnings, S=Size, SY=Shareholder Yield
- 2 Distribution Frequency: A=Annual, Q=Quarterly, M=Monthly
- 3 Ratio of average historical Max. Drawdowns to S&P 500 declines greater than 10%
- 4 RFY=Reaching For Yield Insider Buying Theme; Yield assumes a 50/50 allocation between IVE & RFY

our 1st Client over the next 5 years.