Wealth through ingenuity.

CMG Opportunistic All Asset Strategy
2017 Q3 Quarterly Update

The CMG Opportunistic All Asset Strategy rotated back into an aggressive risk-on position in July and held over 80% of the portfolio in equity positions for most of the quarter. Equity markets have been strong this year, setting new high after new high, and the strategy has been positioned to capture upside with average equity exposure this year of over 70%, more than ten percentage points higher than in 2016. Furthermore, fixed income exposure in the portfolio reached its lowest level in close to a year. In August and September, the portfolio held less than 10% in fixed income positions. Equities, particularly international equities, have been the dominate asset class this year while fixed income has faced a headwind in the U.S. as the Fed continues to normalize monetary policy by increasing rates. In July, the portfolio rotated out of bonds and into financials (which gained momentum during the quarter as rate increases improve the potential for profitable lending) and increased exposure to large cap international equities. The strategy remained aggressively positioned in August, with increased exposure to international equities, specifically regional exposure to Latin America and China. North Korea's continued nuclear tests brought geopolitics back to the front pages resulting in investors bidding up precious metals during the quarter. As a result, the portfolio held exposure to gold for the first time in over a year. After a flat month in August, equity markets climbed higher in September and the portfolio remained well-positioned to capture upside. The strategy remained aggressively positioned in October, albeit with a better balance between domestic and international equity positions. The strategy held the following allocations (individual portfolio allocations may vary) to equities, fixed income, commodities and cash at the end of July, August and September:

	Equities	Fixed Income	Commodities	Cash
July	81.64%	18.36%	0.00%	0.00%
August	82.77%	9.02%	8.21%	0.00%
September	82.95%	8.97%	8.08%	0.00%

Global equity markets continued their steady climb higher during a quarter marked by geopolitics and natural disasters. Investors shrugged aside three Hurricanes, wildfires in Northern California and ongoing sabre rattling in North Korea as the will to own stocks has overpowered all reflexes at risk management: the VIX (the CBOE's measure of 30 day volatility) is at multi-year lows. Disasters and Kim Jung Un are headline grabbers as far as risks go, but the truth is that natural disasters, particularly hurricanes, typically have a stimulative effect on the economy as the cleanup turns to new construction and auto sales jump in response to massive flooding. Scary as the prospect of nuclear war is, nobody's that crazy, right? That seems to be the attitude of investors and it's not unreasonable: global growth is strong and coordinated across major economic areas of the world, corporate profits are still near record highs, commodity markets have stabilized, the EU is not going to fall apart, and BREXIT is still an eternity away. So are the days of drawdowns and market corrections behind us? We don't think so.

POLITICAL HEADWINDS

Since the depths of the financial crisis when Congress failed to initially authorize TARP, the focus of most critics have been on the activist policy of the Fed, the risk of runaway inflation and the perversion of moral hazard. Laissez faire! was the rallying cry of purists – leave the market alone and all will be well. Oddly, that is what is happening now – as far as the Fed is concerned. While controversial, their constructive and active role in supporting the economy is coming to an end. Fed funds, while not on the timetable originally promised, continue to stairstep higher and this past quarter the Fed communicated its plan for winding down its balance sheet. The next act of this economic expansion will be played

by a different cast of characters in the role of Fed Chair and in the role of worst supporting actor, in the form of Congress. There is no one who can play the leading role as the Fed steps back.

In the past year, we have lamented the lack of fiscal support from the government to complement the Fed monetary policy and facilitate a proper handoff of responsibility for economic reform to the two political bodies that can and should do more: Congress and the President. Fiscal policy has by and large been inconsequential aside from minor squalls like the debt ceiling standoff in 2013. That has changed; fiscal policy and politics is now looking like the biggest headwind for the market. Respondents to the recent McKinsey Global Survey agree. In fact, the recent survey highlights a number of paradoxes facing the global economy and the US more specifically. For the first time in six years the majority of respondents (global corporate executives) say their home economies are on the right track. This coincides with strong readings on consumer and business confidence for most of this year. However, when those same executives were asked about the biggest risks to growth, their top two responses were: domestic political conflicts and geopolitical instability. In North America, 52% of respondents cited domestic political conflicts as the largest risk – well ahead of any other region in the world.

After multiple failed healthcare votes and the constant infighting between the Trump administration and congressional Republicans, there is no guarantee that tax cuts will pass. Public support (aside from the corporate sector) has been lukewarm (largely due to the lack of information and the disproportionate cuts favoring the wealthiest Americans and corporations) and there is no guarantee that the deficit hawks in the Republican party will go along with a plan that might add over $2 trillion, or 10%, to America's national debt in the next 10 years. In opposition, Senate leader Mitch McConnell spent the better part of eight years telling Americans and his base that the deficit was America's most serious long-term problem. The current proposal would take the U.S. debt-to-GDP ratio from 75% today to over 100% in a decade. It will take some political chutzpah to now convince true fiscal conservatives that an economy at full employment needs a tax cut of this size. Simulations of the current proposal by Moody's Analytics (which uses a similar model as the Fed, the CBO and the Joint Committee on Taxation) suggests that stronger inflation and higher interest rates are the likely result of the plan, in effect negating the stimulative effects on growth. This was what happened in the early 80s and the result was a recession, a budget crisis and the Fed having to make a U-turn and raise rates. For these reasons, it is likely that Trump, who is no stranger to debt, will select a dove as his appointment for Fed chair. Finally, there is a real risk that the U.S. would face a credit downgrade. All of these factors would, after the initial fiscal sugar high, weigh heavy on long-term growth prospects for the country.

The debate on tax cuts highlights another paradox that shows up in the McKinsey Survey: when asked about growth over the next decade, the second most cited threat was rising income inequality. Additionally, social unrest shows up as the fourth largest threat to growth over the next 12 months, up over 30% since the March 2017 survey. Keep in mind that this is a survey of executives, many of whom stand to benefit from tax cuts that are likely to exacerbate the trend in inequality. In a similar vein, Ray Dalio posted an excellent article on October 23 titled, Our Biggest Economic, Social and Political Issue – The Two Economies: The Top 40% and the Bottom 60%. Here are a few of the highlights that are related to tax cuts, repatriation of assets and inequality:

- Since 1980, median household real incomes have been flat and the average household in the top 40% earns four times more than the average household in the bottom 60%.
- Those in the top 40% now have on average 10 times as much wealth as those in the bottom 60%, up from 6 times as much in 1980.
- Only about a third of the bottom 60% saves any of its income (in cash and financial assets).
- Only about a third of families in the bottom 60% have retirement savings accounts which average less than $20,000.

The current tax cut proposal and the failure of healthcare reform will hit the bottom 60% and the middle class specifically very hard. Namely, they are not likely to benefit from the tax cuts despite having a larger propensity to spend but are likely to face higher healthcare costs. Higher interest rates will also have a larger impact on the bottom 60%. Additionally, any benefits from corporate tax cuts and repatriation (which will likely funnel into shares buybacks and dividends) will flow to the top 40% which has more than twice as much of their net worth in stocks as the bottom 60%. The full article is available **here** and is well worth a read.

Kindest regards,

PJ Grzywacz
President

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CAPITAL MANAGEMENT GROUP
1000 Continental Drive (800) 891-9092
Suite 570 (610) 989-9090
King of Prussia, PA 19406 (610) 989-9092 FAX
www.cmgwealth.com