First Quarter Outlook 2017

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

> ***"We've long felt that the only value of stock forcasters is to make fortunetellers look good...short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children."***
>
> *Warren Buffet*

Client Q & A with ISG

In this issue, we offer up our views and strategies in Q & A format, based on client meetings and other client communications.

Client: Happy New Year to you and everyone at ISG. I always look forward to these early-in-the year meetings and going over your outlook and tactics for the year ahead. To start things off, I'd like your assessments on the Trump election and the new administration's potential impact on the economy and markets. Admittedly, I was surprised by the outcome and even more surprised by the stock market's year-end rally following the election. What is ISG's take on all of this?

ISG: It's always our pleasure to visit with you and, yes, we too were surprised by the market's response following the election. Markets typically dislike uncertainty so consensus thinking was that a Trump election with all his associated unknowns in terms of future policy would have sparked some volatility while the opposite might occur with the status quo candidate in Hillary. As things turned out, the investment community rallied around the possibility that Trump's business-friendly initiatives to lower corporate tax rates, reduce regulation, and increase infrastructure spending might revive the corporate sector's "animal spirits" and get the economy on the right growth trajectory that has been lacking in recent years.

Client: So much for market prognostications. More importantly, can the new administration pull it off?

ISG: Thus far, the markets are betting that they can. The plan to boost U.S. infrastructure spending is welcome, but the intention seems to be to emphasize private/public partnerships rather than federally-funded projects. Setting up such agreements could take time, so we might not see any add-on to GDP growth until next year. Regarding tax cuts, history shows there can be a huge difference between election promises and what eventually is legislated, and there remains among Trump's own party ongoing concerns about debt build-up and lower tax revenues even under faster economic growth. We think changes are in the making but it's quite possible that the administration's plans will be watered down. Furthermore, there might be offsets to some of the business stimulus in the form of slower labor pool growth from restricting immigration, protectionist trade policies and resulting higher import prices. It's a little tough to assess how all this will net out for overall economic growth.

Client: So your final answer is?

ISG: We think it's premature to assess anything at this point. More time will be needed before any verdict can be rendered. We're cautiously optimistic we'll see some pick-up in growth but we're not yet confident enough to alter our current U.S. stock allocations in a meaningful way at this time since a lot of optimism is already baked into today's stock prices.

Client: Given the market's run since the election, are you expecting a pullback should Trump's initiatives fall short of expectations or get bogged down in political haggling?

News Notes:

Welcome George Guerin and clients of Guerin Financial Services (GFS)

We're delighted that the merger between GFS and ISG has been completed as of January 1, 2017. We look forward to sharing in George's 35 years of industry experience and we welcome the clients of GFS into the ISG family!

Remember, Schwab 1099's Often Come Around a Second (and third?) Time

The infamous **Form 1099,** which provides details on your interest, dividends, and capital gain distributions for the past year is **often amended** so for those who are fleeing to warmer climes and trying to file early, please keep this in mind. These reporting adjustments are inherent to the investment industry and all custodians like Schwab must contend with this so delaying your filing allows these amendments to sort out, thus preventing a re-do of your return. Just saying!

Don't Procrastinate. Fund Your IRA's Now!

Don't wait until April to make your 2016 traditional or roth IRA contributions. Many thanks on your help with this!

Investment Security Group, Inc. (ISG) is a Registered Investment Advisor providing individuals with creative investing and financial planning solutions. ISG's research is thorough and independent and our ultimate goal is to enhance your life experience through prudent financial decisions.

News Notes, continued:

Upcoming Increased Trading Aimed at Saving You Money

In our ongoing efforts to lower your mutual fund investment expenses, please note that some of your upcoming trade activity may be solely aimed at moving you **within an existing mutual fund position** from a retail share class over to a lower expense institutional share class. These transactions are being expedited on a fund-by-fund and client-by-client basis, depending on size of position, tax consequences, among other factors. Please call your ISG advisor should you have any questions.

BDCA Share Repurchases

The management of BDCA (Business Development Corporation of America) has informed us that they intend to repurchase 39% of the amounts requested by ISG in December. The next share repurchase window is scheduled for mid-year, 2017. Please contact your ISG advisor for additional details or questions. Thank you!

ISG: Predicting these short-term sell-offs is always difficult, but we would not be surprised to see a pullback should reality fall short of expectations. That is the nature of stock market behavior. Depending on the severity of the decline, we would be inclined to increase our ante in U.S. stocks at that point.

Client: Are U.S. stocks overvalued?

ISG: Perhaps modestly based on a combination of measures…but nowhere near some of the extremes of the past. If economic growth increases, valuation should not be an impediment to further gains in U.S. stocks over the coming year, although getting to those gains might require some fist-clinching along the way. Other regions may offer better relative opportunities.

Client: That brings up a point of concern for me when looking at my globally diversified stock allocation. For several years now, you have been touting the virtues of foreign stock exposure and from where I sit, this foreign exposure hasn't added much to my scorecard over this period. Do you agree?

ISG: That's a fair statement. But for several years now, our analysis has supported maintaining foreign stock exposure for a number of reasons, including better valuations, higher yielding dividends, and, very importantly, lower expectations. That third point is an important one, as stock rallies are usually ignited when reality exceeds expectations. This could come in the form of better-than-anticipated growth or as in the case of Europe several years ago, of things "becoming less worse."

Client: But why would I invest in a place like Europe when there has been better growth going on here in my own back yard?

ISG: Please understand however, that markets do not always track with the economy's growth rate, especially if prices are already factoring in that growth. In the U.S. case, stocks have been moving along well the last couple of years despite a sluggish growth environment. That seems somewhat inconsistent to us given that valuations were not cheap to start with. It also raises another question of whether prices have been distorted some by excessively easy money policies…a topic perhaps for another meeting. In Europe's case, prices appear to reflect an excessive amount of pessimism. Justified? Perhaps. But it would not take much improvement to beat these current low expectations to move stock prices upward.

Client: So with that theory in mind, where are we today?

ISG: Almost across-the-board, our foreign stock strategies thus far this year are outperforming U.S. stocks despite the Trump stock rally continuing in full swing. No one can say where we'll be at year-end, but we continue to believe our global stock approach is supported by solid risk/reward assessments between asset classes. Diversification, however, means that at any point in time one asset class will be outperforming while others lag.

Client: So why can't we concentrate in the "hot" regions and move later when conditions warrant a change?

ISG: We'd like to say that we could accommodate your request with pinpoint precision…but we know from experience we can't. Fundamental assessments of markets and cycles helps but we're humble enough to know it's not a full proof solution. Markets can be unpredictable and irrational and tend to overshoot when moving up and down. For example, in the mid to late nineties, tech stocks were grossly overvalued, but that bubble did not burst until the spring of 2000. There's been a case for foreign stock investing, but for the last several years U.S. stocks have stolen the show. That will change. We just don't know exactly when. That's why diversification makes sense for those who are looking for a smoother investment ride.

Client: Ok, but which foreign regions look most attractive to you?

ISG: The main regions we invest in – Europe & Asia – offer different but equally appealing investment options, so presently our foreign strategy encompasses both. Europe contains many great businesses that have a global reach but in general the play is that business conditions, while not as promising as here in the U.S., are improving more than what current stock prices reflect. In Asia, it's more of paying a reasonable price for a long-term growth story fostered by faster moving economies, younger, more productive workforces, and rapidly rising standards of living as these economies mature. The exception is Japan which is strapped with lots of debt and an aging workforce. Stocks are cheap there, but the macro picture is so cloudy that we defer to our foreign stock pickers who may add Japan to their portfolios on a very selective, company by company basis.

Client: You haven't mentioned emerging markets for a while and how does China factor into your thinking these days?

ISG: The rebound in oil and other commodity prices has been a positive for many of the export-dependent emerging economies, but slowing demand for these exports, due primarily to China's waning appetite, will be an offset to growth. A firm dollar and trade uncertainty might also represent a headwind for capital flows to the EM universe. The bottom line is that the growth deceleration we've seen in recent years in the emerging economies has run its course but a major new boom is not in the works. For now, we're comfortable using two managers who hand pick from this area as part of their global/international portfolios. One manager seeks small, fast-growing businesses while the other favors established, dividend-paying companies… a good complement in our opinion.

China is always on our radar screen as its growth rate affects many global trading partners and markets. It remains an unbalanced and fragile economy but the authorities have enough policy flexibility to avoid a hard landing, at least for the foreseeable future. The global economic watchdog, the IMF (International Monetary Fund), predicts that 2017 growth will come in below the 2016 level. As previously stated, we always keep a close eye on China.

Client: Alright. I'd like to turn our attentions to the part of my portfolio that's supposed to allow me to sleep at night, namely my bonds…although lately, that part is keeping me up too. Interest rates and inflation seem headed upward which, in turn, erode a bond's investment value and overall return. I've been told bonds serve as "insurance" against a stock market decline. I'm certainly for that as I am suspicious of stocks given all the economic and policy uncertainties around the world. Yet the return outlook for bonds with these rising rate headwinds seems unattractive, at best. What are your thoughts about all of this?

ISG: Generally speaking, your concerns are justified. For sure, the 35-year trend of declining interest rates (and increasing bond prices) has ended. Moving into a rising rate regime will present its own set of challenges for bond strategists. But when we dig a little deeper, we perhaps come up with a slightly different answer for you. First, not all bonds react the same way to rising rates. Ironically, the bonds that are considered the "safest" (government backed and higher quality corporate bonds) suffer the most carnage when rates rise, so diversifying into less "interest-rate sensitive" bonds is an essential strategy in this new regime. We began the process two years ago by using bonds whose results are more closely tied to, say, a homeowner's ability to repay their mortgage (ie "mortgage-backed securities") or an underlying asset's ability to produce expected cash-flows (ie. "asset-backed securities") or bonds whose results have nothing to do with interest rates and everything to do with a property/casualty insurer's claims from natural disaster events from storms, earthquakes, etc (ie. reinsurance bonds). In combination, an overall strategy that carefully blends in these alternative elements with traditional bond products may go a long way to navigating through rising rates without compromising their defensive characteristics.

Client: My head is starting to spin…

ISG: Remember, that the bond market is vast and some of the flexible strategies we are now using move carefully into some of the non-traditional niches, including foreign bonds or bank loans that have floating rates, for different sources of return and response to rising rates. And a final point, at least here in the U.S., is that we think all the noise about the rise in rates and inflation is a little bit too loud. Current supply and demand conditions do not warrant a big jump in inflation and rates at this time, particularly if businesses start ramping up again to keep pace with any increases in demand. This is something we're watching closely.

Client: I hope you're right. And after hearing that, I'll leave the bond business up to you guys. One final question: I've not heard you pounding the table for any particular asset class or idea. Is there anything today you are excited about?

ISG: We agree that nothing seems to be "on sale" today and, certainly, it's a time to tread carefully with all the economic and policy uncertainties worldwide. But as we said earlier, we look for more advances in U.S. stocks, particularly if growth picks up some. And "small is beautiful" may become the new investing mantra since the stocks of smaller U.S. businesses look to benefit the most from Trump policies which look to attack rising health care costs, excessive regulation, and income taxes. Bottom line: Expect more small to medium stock exposure in your portfolio.

Client: And overseas?

ISG: We expect –selectively- foreign stocks to close their gap some with U.S. stock performance of the last several years. The same may hold true for bonds. And as far as other elements of the more defensive side of your portfolio, income-producing real estate (which we've increased in your account over the last year) along with creative bond strategies remain a cornerstone of our overall strategy.

Client: I appreciate you explaining the benefits of being well diversified . Given the state of the global economies and markets these days, I'm inclined to favor having more "hedges" with a globally diverse strategy.

ISG: We obviously agree.

Client: Many thanks for your time today. It's been a productive meeting for me.

ISG: It is always our pleasure. Our best to you and yours for a happy and healthy 2017.