MARKET COMMENTARY

FIRST QUARTER 2017

First Quarter Overview

U.S. equities ended the first quarter of 2017 with a positive return despite negative performance in March. The S&P 500 posted a mid-single-digit advance, while small cap stocks represented by the Russell 2000 Index trailed their large cap brethren with a low, single-digit gain. The fixed income sector, as represented by the Barclays U.S. Aggregate Bond Index, bounced back after losses in the fourth quarter of last year to end the first quarter with a small gain. The U.S. dollar Index (DXY) lost ground, which helped unhedged international investments. Emerging market equities enjoyed a double-digit return, while international developed markets (MSCI EAFE) closed with a high single-digit gain. Commodity prices had remained steady until falling in March to end the quarter with a mid-single-digit loss. Oil prices swooned, but gold closed approximately 8% above where it ended in 2016.

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The Rise and Influence of Populism

Hillbilly Elegy: A Memoir of a Family and Culture in Crisis by J. D. Vance, recounts the author's formative years surrounded by a family and community influenced by Appalachian values. Vance describes the hopelessness of those around him and their worsening outlook in the absence of meaningful employment opportunities. *The New York Times*' review of the book included the following:

> *Now, along comes Mr. Vance, offering a compassionate, discerning sociological analysis of the white underclass that has helped drive the politics of rebellion, particularly the ascent of Donald J. Trump.*[1]

In a microcosmic way, Vance's story provides an explanation for the populist uprisings of the recent past, as well as any potential future uprisings. Populism manifests in a rebellion of the "common man" against the establishment or a society's elites. This powerful sentiment has quickly and shockingly translated into geopolitical tremors that have the power to meaningfully impact the economic landscape of the future.

The rise of populism carries such potential influence over investment markets that sophisticated investors are taking notice. Ray Dalio and Bridgewater Associates recently released a smartly written piece titled "Populism: the Phenomenon" in which they examine how populism typically germinates, grows, and runs its course.

In recent years, the influence of central banks on markets has been undeniable, which makes the following excerpt from Bridgewater's report all the more striking:

> *Given the extent of it now, over the next year populism will certainly play a greater role in shaping economic policies. In fact, we believe that populism's role in shaping economic conditions will probably be more powerful than classic monetary and fiscal policies (as well as a big influence on fiscal policies).*[2]

Often, the label of "populist" is meant to imply philosophies and policies akin to the socialist despots in Latin America, or history's most brutal dictators spearheading mass genocide. For that reason, politicians in power often apply the label to their opponents. However, the populism of the 21st century does not exhibit such extremism, but does appear highly influential and pervasive, spanning Western civilization from Donald Trump and Bernie Sanders in the U.S., Brexit in the U.K., the rise of the National Front political party in France, and the Five Star Movement in Italy, among others.

To suggest that nationalistically charged sentiment could lead to the dissolution of the European Union is no exaggeration. France's presidential hopeful, Marine Le Pen, the insurgent candidate from the country's National Front party, has promised that she will present her people with a leave-the-euro referendum if she wins this spring. Even if she wins (certainly not a foregone conclusion), a referendum would still not necessarily take place, but the prospect strikes fear in the hearts of many observers. The Economist suggested that if Le Pen pulls France out of the euro, it would trigger a financial crisis and doom a union that, for all its flaws, has promoted peace and prosperity in Europe for six decades.[3]

Recall that not long ago (2011), the specter of Greece leaving Euroland sent shockwaves around the globe, resulting in a nearly 20% decline in the U.S. stock market. Admittedly, the Greek situation posed the threat of a potential sovereign debt default that would be less likely for France, but France has the world's 6th largest economy–Greece's economy is only 8% the size of France's.[4]

The rise and influence of populism is undeniable. The tenor of potential conflict in its wake is far less certain. More from Bridgewater:

> *Populist leaders are typically confrontational rather than collaborative and exclusive rather than inclusive. As a result, conflicts typically occur between opposing factions (usually the economic and socially left versus the right), both within the country and between countries. These conflicts typically become progressively more forceful in self-reinforcing ways.*
>
> *In monitoring the early-stage development of populist regimes, the most important thing to watch is how conflict is handled—whether the opposing forces can coexist to make progress or whether they increasingly "go to war" to block and hurt each other and cause gridlock.*[5]

For investors, the words "block" and "gridlock" should give pause in that they represent potential impediments to economic growth, the primary force behind long-term returns in investment markets around the world. For example, concerns that the UK may be facing many years of slower-than-normal economic growth have likely contributed to weakness of the pound post-Brexit.

Early insight into how Trump may deal with conflict was seen in the recently failed attempt to retract the Affordable Care Act (ACA). Trump's insistence that tax reform would have to wait until the ACA was a thing of the past temporarily roiled markets that had steadily climbed since the Presidential election on expectations that lower taxes might spark economic growth. Conflict resolution will be necessary to implement the pro-growth policies that the markets have already priced in to earnings expectations.

Populists are generally nationalistic and protectionist, and Trump's rhetoric supports the notion that his views are populist-aligned. With protectionism and anti-globalization comes the potential for tariffs and limits on trade. From the perspective of the global economy, trade supports economic growth; thus it stands to reason that constricted trade could lead to diminished growth and stunted corporate profitability, likely placing downward pressure on many areas of the global investment universe.

Many have speculated on the potential fallout from this changing geopolitical landscape where populists are unseating the status quo. For the first time in years, the Federal Reserve is not consistently dominating the investment-related narrative, but ignoring the Fed would be unwise. Peter Boockvar from the Lindsey Group, an economic advisory firm that focuses on macroeconomic trends, drafted an interesting note on the subject:

> *As for markets, it has been refreshing to see the Fed fall into the background of the daily discussion ever since the election. I'm as enthused as anyone about tax cuts (even though we don't know what final form will look like) and regulatory relief (but worried about trade protectionism and immigration bans). But to think that somehow the Fed is no longer relevant to both the economy and markets as they step up rate hikes I think is delusional. I think we are about to see a likely heightened test of how the US economy and markets will handle a further rise in the cost of capital as rate hikes happen more frequently in the US and QE around the world limps on its last legs.*[6]

The collective markets' potential responses to populist influences are exactly that–potential. There is unquestionably risk in uncertainty, particularly regarding political regime change, but the story of how that change will affect the financial markets has yet to be told.

Central banks, however, exert direct control over rates of interest, the magnitude and direction of which enjoy a well-documented history of market-driving consequences. Although the recent rise of populism already wields significant force on the global stage and has the potential to grow in power and influence, FEG believes that in many cases, central bankers carry a larger and heavier "stick" that investors ignore at their peril.

Equities

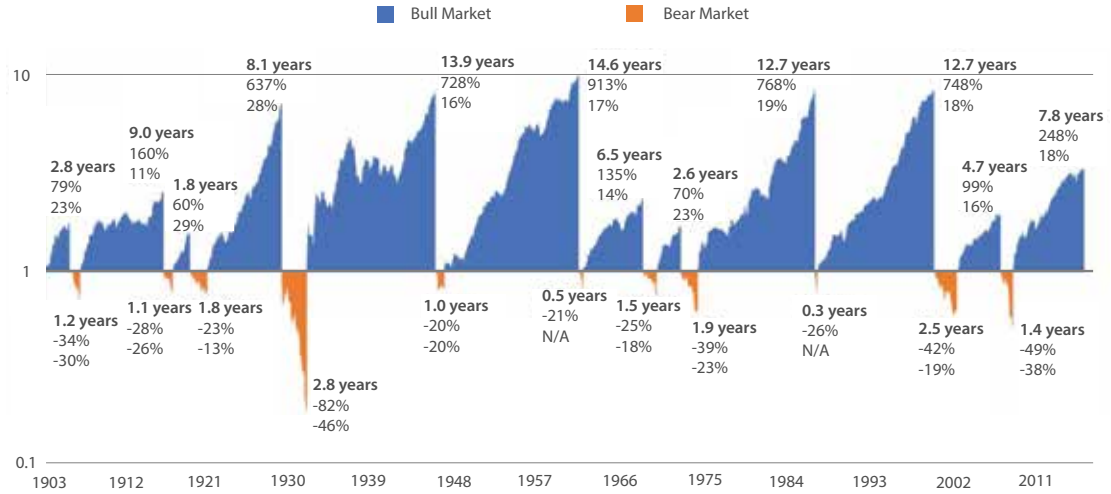
In the first quarter of 2017, the U.S. equity market passed the 8-year anniversary of the post-Great Financial Crisis (GFC) low on March 9, 2009. One dollar invested in the S&P 500 at the stock market low in 2009 grew to over $3.50 by the end of the first quarter this year. For perspective, that same asset growth would take 28 years to achieve with a 5% annualized return–FEG's current capital market projection for the next decade.

Many investors are pondering whether they should prepare for an impending top, given the duration and magnitude of the bull market in U.S. stocks. As mentioned previously, FEG's expectation for long-term returns of U.S. stocks is approximately 5% annualized. This projection is forward-looking and largely predicated on currently-elevated price/earnings multiples that, at similar levels in the past, have portended below-average subsequent returns.

Although FEG believes future performance will pale relative to recent performance, we do not profess the prescience to predict a near-term stock market peak. In fact, when the current bull is placed alongside others throughout history, it appears altogether average. In a February note, quantitative asset management firm Newfound Research shared the U.S. Bull and Bear Markets visual, which provides stunning perspective.[7]

U.S. BULL AND BEAR MARKETS

1903–2016



Source: Robert Shiller's data library. Calculations by Newfound Research. Bull markets are defined from the lowest close reached after the market has fallen 20% or more to the next market high. Bear markets are defined from the last market high prior to the market closing down at least 20% to the lowest close after it's down 20% or more. Monthly data is used to make these calculations. Past performance does not guarantee future results.

From 1903 to 2016, there were 12 bull markets in the S&P 500. The average bull market lasted 8.1 years, with a total return of 387%. The average bear market lasted 1.5 years, with a total loss of 35%. The current bull market is the 7th longest and the 6th strongest. For the market to be the longest ever, it would have to continue through the fourth quarter of 2023. For it to be the largest ever, the S&P would have to return another 665%.

A separate concept that some have suggested portends an impending top in the stock market has to do with the persistently low volatility environment. Exceptionally low volatility, the thought goes, coincides with complacent investor sentiment, which suggests a market peak must be near.

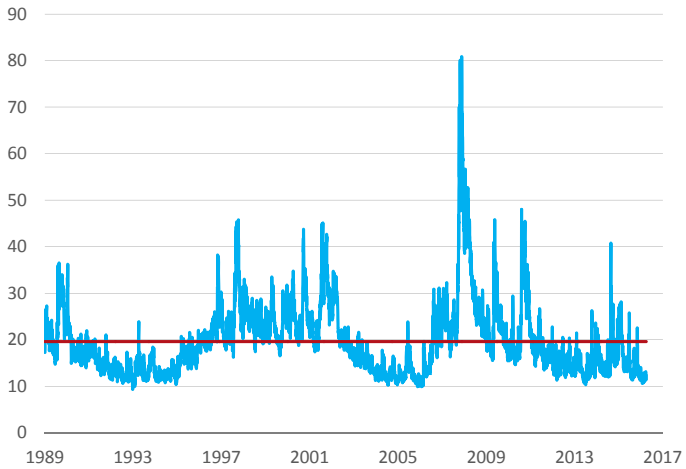
However, as history has shown, a low volatility regime can continue unabated for years at a time; just because volatility is low does not necessarily mean a period of higher volatility must be right around the corner. The behavior of the CBOE Volatility Index (VIX) serves as clear evidence of this.

Data on the VIX goes back to 1990. The average level has been 19.7. In recent weeks, the VIX has frequently been priced at or around 12, with several days pricing even lower. Levels at 12 or lower have occurred just 8.2% of the time since 1990, representing what some might consider among the most extremely complacent. However, such levels have not regularly predicted market doom. Specifically, the average 1-year return of the S&P 500 after the VIX posts a below-12 reading has been 9.9% since 1990, which is actually better than the 8.9% average return of the stock index over that same period.

One other interesting metric to which many seeking to call a market top have pointed is the ratio of NYSE margin debt to GDP. High levels are considered a sign of extreme complacency and have previously occurred near market tops. As the graph illustrates, peaks have sometimes preceded market declines and recessions of the past, but not always. Additionally, with interest rates still exceptionally low, the actual complacency represented by this metric could be skewed to downside. Thus, FEG views this market-top-prognostication tool with a skeptical eye as well.

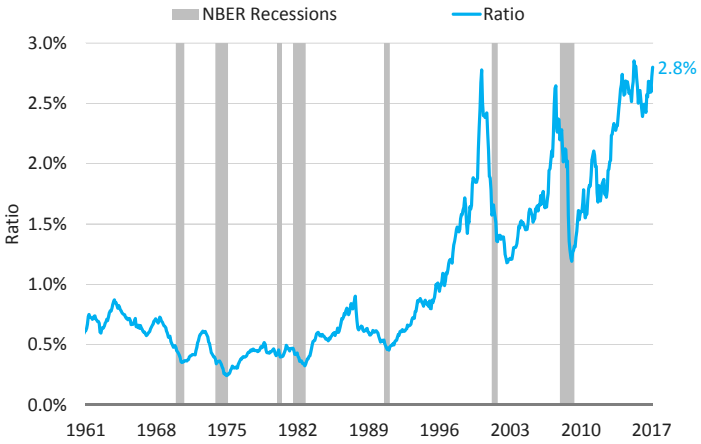
FEG's outlook for large cap U.S. stock market performance is only about half that which has been posted over long-term periods of the past. However, a less-than-optimistic outlook should not be construed as a divination that a near-term market drawdown is impending. A retracement to levels seen prior to the Presidential election would not come as a surprise, but we do not believe that anyone has the ability to offer short-term market prophecy. Furthermore, neither a bull market's magnitude relative to those of the past, nor recent levels of volatility, nor margin magnitude can provide actionable guidance in that regard.

CBOE VOLATILITY INDEX SINCE 1990



Data sources: NYSE, NBER, and Bloomberg L.P.
Note: NYSE margin debt data as of February 2017 and GDP data as of 4Q2016

NYSE MARGIN DEBT AS % OF GDP AND CYCLES



Data sources: NYSE, NBER, and Bloomberg L.P.
Note: NYSE margin debt data as of February 2017 and GDP data as of 4Q2016

Fixed Income

One of the areas upon which the Trump administration is expected to focus is regulation, with the thought that a less onerous regulatory environment could support economic growth. The implications associated with deregulation, as well as the potential wholesale changes at the Fed, could have significant impacts on fixed income liquidity and the future direction of interest rates, both of which can exert meaningful influence over bond market performance.

Following the most significant financial crises, the American people and government officials usually clamor for action to ensure that what has just occurred will not likely happen again. History is replete with examples of these kinds of public promises, but many end up carrying unintended consequences, including those that run counter to intentions.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is the response to public outcry following the GFC. With the Trump administration appearing bent on regulatory reform, it is expected that Dodd-Frank could be either eliminated or severely modified.

An important subset of Dodd-Frank that carries investment-related implications is the so-called “Volcker Rule,” which seeks to limit proprietary trading conducted by banks. A potential unintended consequence of the Volcker Rule is that certain areas within fixed income now exhibit less liquidity than before, which is particularly ironic considering a lack of liquidity can contribute to the spread of banking crises, the exact public ill Dodd-Frank was designed to prevent.

In a research paper published December 22, 2016, staff members from the U.S. Federal Reserve indicated that the 2015 implementation of the Volcker Rule had a harmful effect on corporate bond liquidity.[8] The paper concluded that firms subject to the Volcker Rule become "less willing to provide liquidity during stress times." While dealers not affected by the Volcker Rule have stepped in to provide liquidity, the Fed staffers found that the net effect is a less liquid corporate bond market.

This finding is important in considering the true risk–beyond standard deviation of returns–exhibited by certain fixed income subcategories. Few readers of these pages need to be reminded that the 2008 financial crisis was worsened by a liquidity crunch. If the regulation is lifted and banks once again serve the same caliber market-making role they had prior to the GFC, the liquidity risk in corporate debt could be mitigated. That said, meaningful changes to this regulation are not currently known–in terms of either type or timing.

Beyond the Fed-conducted Volcker Rule analysis, investors should closely observe personnel turnover at the Fed, especially in light of the opportunity Trump will have to influence the composition of the central bank in years to come. The Federal Reserve's lead architect of post-crisis financial regulations, Daniel Tarullo, plans to resign soon, giving President Donald Trump more freedom to remake the central bank and to accelerate a deregulatory agenda by putting his own appointees in charge of overseeing Wall Street.

Additionally, Trump's criticism of Chair Yellen is widely known. The President clearly seeks to place his own stamp on the Federal Reserve, and it is unlikely that stamp will carry an overly hawkish view. Therefore, despite the recent Fed-induced rate hikes, particularly restrictive policies seem unlikely in the near-to-intermediate term. The effect that these concepts will have on the future direction of interest rates, inflation, and the performance of a wide variety of fixed income securities is likely to prove highly influential.

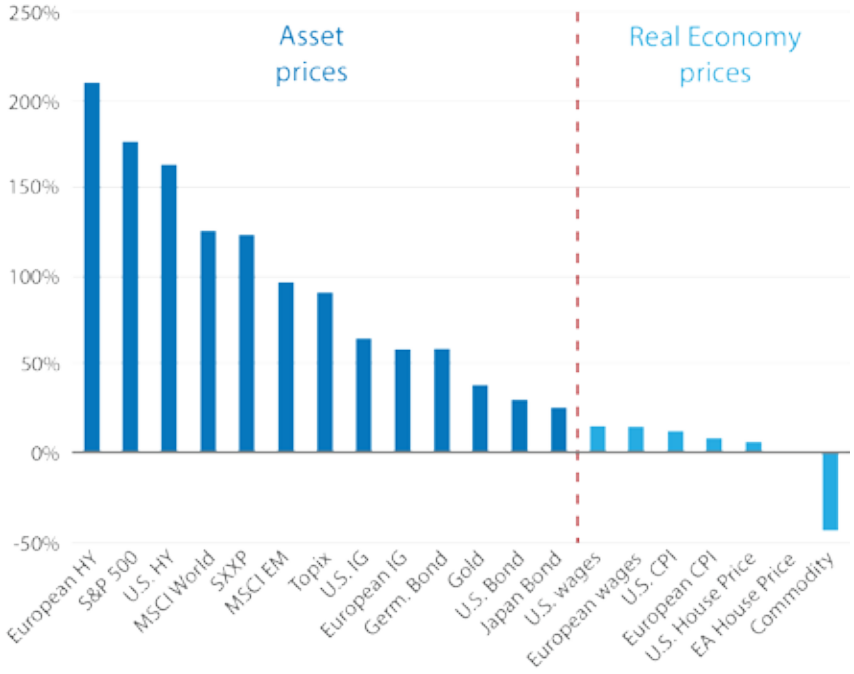
Real Assets

Since the end of the GFC, central banks have employed both conventional and unconventional actions designed to reflate the financial system. Both bonds and stocks have seen massive price increases, while wages and consumer prices have stagnated.

A graph created by Peter Oppenheimer, the chief global equity strategist at Goldman Sachs, shows the stark performance differences between asset prices and real economy prices since January 2009.

DIFFERENCES BETWEEN ASSET PRICE AND 'REAL ECONOMY' INFLATION

TOTAL RETURN PERFORMANCE IN LOCAL CURRENCY SINCE JANUARY 2009



Source: Goldman Sachs

In an attempt to spark economic reflation since the end of the financial crisis, central banks have inflated the value of financial securities while actual economic inflation has remained stagnant. The disconnect is stunning and speaks to a potential source of the populist uprisings discussed previously.

An observer of the graph may become concerned, seeing “bubble” risk that could ultimately end badly for financial assets given their high valuations and the inherent unsustainability of this divergence. Although it is just as possible that rather than the left side falling, the right side of the graph might move to catch up. Said a different way, should we be concerned about an onset of inflation?

The populism thread woven throughout these pages has an application here as well. Although admittedly impossible to predict, the advent of Trump administration stimuli could very well lead to heighted inflationary pressures.

The initial spark from such policies could set off a self-reinforcing blaze of new spending, with organizations executing on planned investments sooner than originally anticipated in hopes of predating higher prices. If, as was postulated previously, the composition of the Fed becomes largely dovish, inflation might run unchecked for at least a limited period of time. Further, history is replete with examples of countries pushing for growth beyond the limits of their economy and triggering inflation and large budget deficits.

One other point to consider is the vested interest the Trump administration may have in a weaker U.S. dollar–an inflationary development. Domestic manufacturers would find more competitive footing, a desire often emphasized by the President and one that could benefit many of the disaffected who voted him into office.

To date, a meaningful spike in inflation has yet to occur. The toll inflation can take on the utility of an investment portfolio is significant. Importantly, a reactive response to inflation is nowhere near as effective as a proactive one.

Commodities are commonly considered an effective hedge against unexpected bouts of inflation, and certainly historical precedent for that exists. Accessing commodities in pure form can be challenging, and using financial instruments, namely futures, is imperfect. Commodities may continue to provide mitigation against the ravages of inflation despite frequent bouts of high volatility, periods of negative roll yield when the term structure of commodity futures contracts is in contango, and de minimis income from collateral in a low interest rate environment. However, FEG believes that the risk of runaway inflation in the very near term is, at least currently, limited.

In contrast to commodity futures, we believe a wealth of opportunities exist with private natural resource mandates for those investors with the ability to access them. As is the case with nearly all areas of private investing, manager selection can determine whether the investment ultimately proves successful or otherwise.

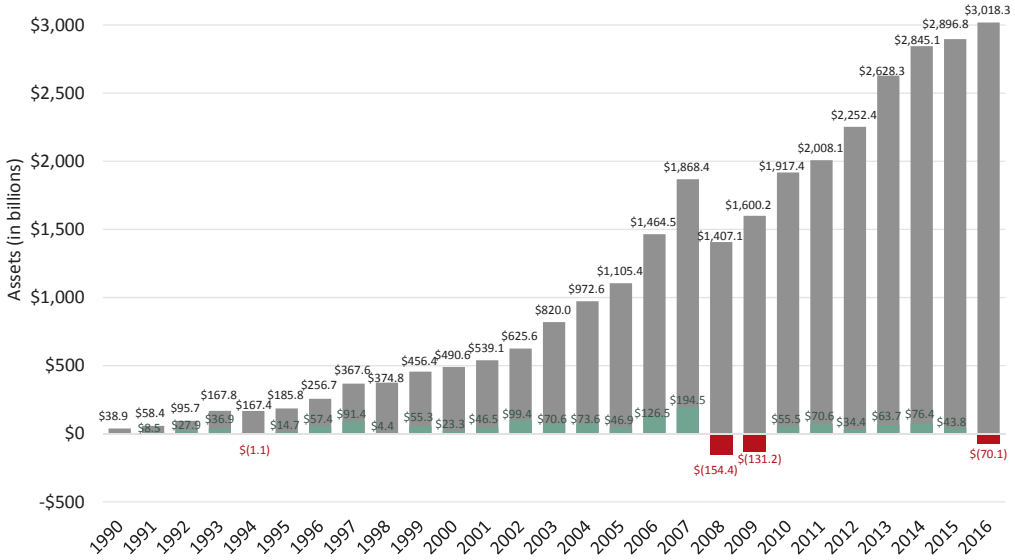
Diversifying Strategies

"Hedge Funds are Dead." "A Day of Reckoning." "Hedge Fund Apocalypse." "The Culling of Hedge Funds."

These quotes are symptomatic of attention-grabbing media headlines that, without perspective, may lead an investor to believe that the hedge fund business is about to flame out in a glorious fashion. The graph provides a more tempered, and perhaps more objective, point of view.

ESTIMATED ANNUAL GROWTH OF ASSETS / NET ASSET FLOW

HEDGE FUND INDUSTRY 1990–2016



Source: HFR Global Hedge Fund Industry Report - Year End 2016, www.HedgeFundResearch.com

In 2016, the industry experienced net outflows as illustrated by the red at the bottom of the 2016 bar. Calling these outflows "fractional" relative to the total assets under management falls short of the emphasis needed to portray how minuscule the outflows truly are.

The hedge fund industry is changing, reflecting some disappointment in returns and a more difficult investment and regulatory environment. These changes have been occurring gradually for a decade, largely at our prodding and that of other investors. Fee compression and a reduction in the total number of hedge funds are both healthy realities. Just like any other small business, a hedge fund that does not meet its client's expectations, should and will go out of business. While we utilize hedge funds for appropriate client portfolios, we do so opportunistically and are constantly comparing the opportunity for hedge fund strategies and their potential for diversification against all other available investment options for our clients. If a strategy no longer warrants its place in a portfolio we act quickly to remove it. If a manager is not meeting our expectations, we terminate them from our portfolios. Separately, the future environment for certain hedge fund substyles could become more fruitful, such as event-driven strategies, including merger arbitrage. A number of highly-levered industries undergoing significant transformation–including energy, retail, healthcare, and media–may prove vulnerable to buyouts and takeovers in the future. Together, these groups represent 40% of the high yield market, which could lead to a greater number of attractive opportunities for skilled event-driven managers.

Additionally, there continues to be talk of tax reform—including a one-time exception for U.S. corporations to repatriate cash held abroad in subsidiaries located in lower taxed areas. While this one-time tax rate would be a dramatic reduction from current rates, it would not be free. Companies will not pay a 10-15% tax only to park cash into a corporate savings account earning essentially zero. If companies repatriate this cash, it likely will be used for acquisitions, debt reduction, stock buy-backs, special dividends, etc. This would be expected to further expand the number of favorable opportunities to which skilled hedge funds have access.

Finally, consider the dramatic recent decline in cross-asset correlations illustrated in the graph:

GLOBAL CROSS-ASSET CORRELATIONS HAVE FALLEN CLOSE TO 10Y LOWS

Data source: Morgan Stanley Research; data as of January 11, 2017

Relative value hedge fund strategies find it difficult to post strong performance when correlations among assets are high. By contrast, lower cross-correlation regimes offer the potential to uncover opportunities to add value. Combined with the potentially improved landscape for event-driven strategies, lower cross correlations present reason to believe the future for hedge funds may be brighter than in recent years.

Conclusion

Populist ideas and leaders have been driving the geopolitical narrative of late. Their future impact could result in dramatic changes in the political landscape, having repercussions for economies and markets around the world. Perhaps even more significantly, the U.S. Federal Reserve recently enacted a third rate hike in just over one year, and economic conditions in Europe have improved to the point that the European Central Bank is contemplating the end of their quantitative easing bond-buying program. How markets react to a less accommodative monetary world remains to be seen.

As usual, uncertainty abounds, but brings with it opportunity. Active managers in general and hedge funds in particular may now be more favorably positioned than they have in many years. Emerging market equities have found their footing and their currencies have largely stabilized, with many now ascending; select private equity, energy, and debt investments could result in outsized gains in the absence of broad-based private opportunities. Regardless of what the future brings, FEG believes an investment portfolio built on sound fundamentals and a long-term vision, which resists the temptation to overpay, is well diversified by global sources of risk, and targets highly focused, skillful active managers with demonstrated competitive advantage will have a favorable chance of achieving performance goals.

FOOTNOTES

1. Jennifer Senior, Books of the Times, *The New York Times*, “Review: In ‘Hillbilly Elegy,’ a Tough Love Analysis of the Poor Who Back Trump.” August 10, 2016.
2. Ray Dalio, Steven Kryger, Jason Rogers, Gardner Davis, Bridgewater Associates, LP, “Populism: The Phenomenon.” March 22, 2017. Bridgewater.com.
3. *The Economist*, “France’s next revolution, The vote that could wreck the European Union, Why the French presidential election will have consequences far beyond its borders.” March 4, 2017.
4. "World Economic Outlook Database." International Monetary Fund. October, 2016.
5. Ray Dalio, Steven Kryger, Jason Rogers, Gardner Davis, Bridgewater Associates, LP, “Populism: The Phenomenon.” March 22, 2017. Bridgewater.com.
6. Peter Boockvar, The Boock Report, “Fed Worries, Home Sales, Income, Spending and Inflation and more…” January 30, 2017.
7. Justin Sibears, “Anatomy of a Bull Market,” Newfound Research, February 13, 2017. Thinknewfound.com.
8. Bao, Jack, Maureen O’Hara, and Alex Zhou (2016). “The Volcker Rule and Market-Making in Times of Stress,” Finance and Economics Discussion Series 2016-102. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2016.102.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

The Bloomberg Barclays Capital Aggregate Bond Index is a benchmark index made up of the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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