



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Third Quarter of 2016

Leigh Bivings, Ph.D., CFP®



Artemis Financial Advisors, LLC

54 Chandler Street
Boston, MA 02116
617-542-2420



Executive Summary

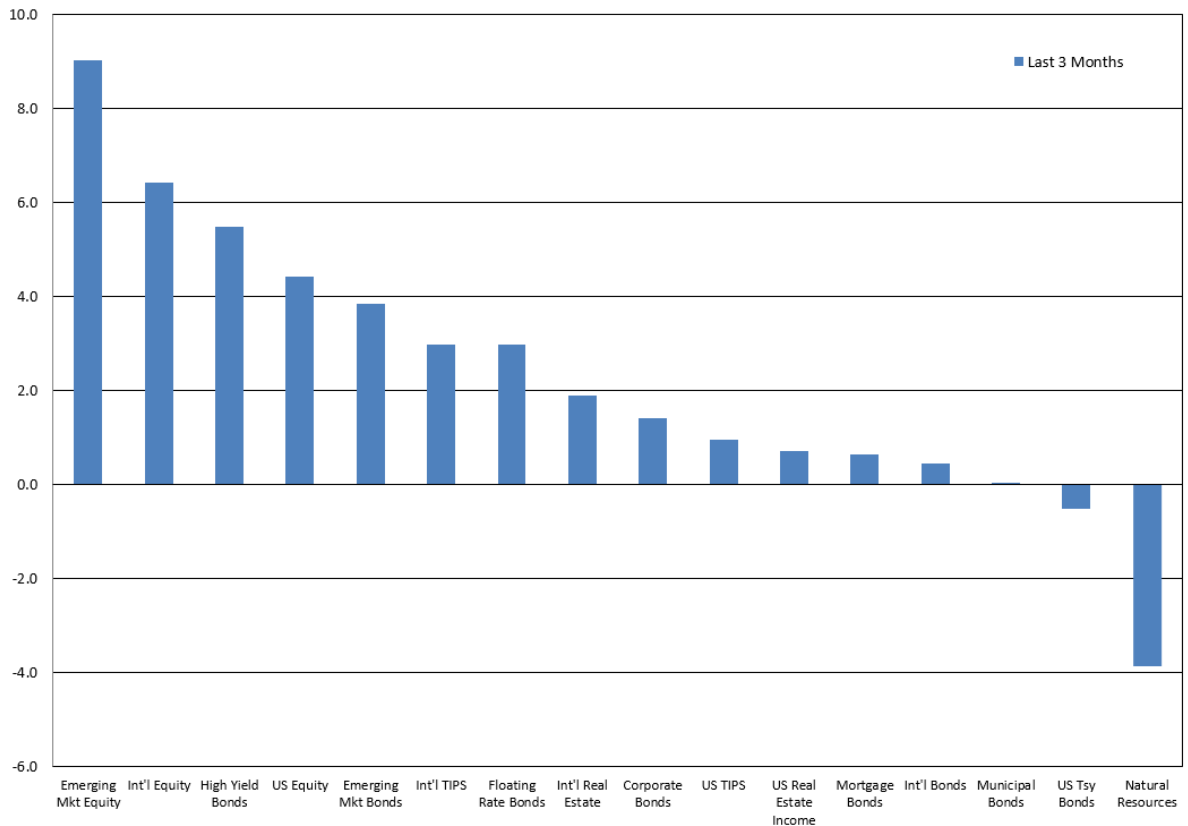
- 3rd Quarter. It was a positive quarter for global equities as markets recovered quickly after the initial shock of the late-June Brexit vote. Expectations of additional monetary accommodation and stable global economic data provided a nice backdrop for markets to move higher. The U.S. total market increased by 4.4%, and the S&P 500 increased by 3.9%.
- For the first time in quite a while, international developed markets outperformed the U.S., with the EAFE (Europe, Australasia and Far East) index gaining 6.5% in dollar terms. Emerging market equities were the best-performing asset class, increasing by 9.2%.
- In sharp contrast to earlier this year, interest rates across the U.S. fixed income markets increased in the third quarter, which muted returns for interest-rate sensitive segments of the fixed income market. Municipal bond returns were flat, and Treasuries posted negative returns of -0.3%.
- 4th Quarter. We focus our attention this quarter on trade politics and the Presidential election, with an attempt to review who have been the winners and losers of the massive increase in global trade over the last 20 years, and why we are seeing more opposition to trade agreements in this election cycle. We also examine the candidates' views on this topic, and in which ways their proposed policies may fall short.
- In particular, we argue that Donald Trump lacks even a basic understanding of economics and that his proposals to close the border, deport 11 million undocumented workers, and stop the H-1B visa program would be a sure-fire way to kill economic (and stock market) growth. Hillary Clinton's proposed policies are much more sensible but still fall short by not adequately and sufficiently assisting those who have been most harmed by trade liberalization. Opposing additional trade liberalization is not the answer.
- Artemis portfolios again performed well in Q3, as our overweight to small companies domestically and our (tactical) overweight to credit paid off. Poor returns in the municipal bond sector were the only drag on performance.



Quarter in Review

It was a positive quarter for global equities as markets recovered quickly after the initial shock of the late-June Brexit vote. Expectations of additional monetary accommodation and stable global economic data provided a nice backdrop for markets to move higher. The U.S. total market increased by 4.4%, and the S&P 500 increased by 3.9%. (See Figure 1.) The difference was largely due to stellar performance by smaller companies, which increased by just over 9.0%.

Figure 1: Market Performance by Asset Class in Q3 2016 (percentage points)



For the first time in quite a while, international developed markets outperformed the U.S., with the EAFE (Europe, Australasia and Far East) index gaining 6.5% in dollar terms. European equities were supported by a generally encouraging second quarter reporting season, and Asian equities performed strongly on the back of positive policy stimulus from China. Nevertheless, the macroeconomic data coming out of Europe continued to indicate



lackluster growth (0.3% for Q3) and low inflation. Towards the end of the quarter, the focus turned to European banks and their (lack of) financial health.

Emerging market equities were the best-performing asset class, increasing by 9.2%, helped by some local currency appreciation. The turnaround has been spearheaded by a rebound in emerging market manufacturing activity, which has benefited from policy-driven stabilization in China (i.e. substantial fiscal stimulus measures driving import demand) and the quest for higher-yielding assets by investors.

In sharp contrast to earlier this year, interest rates across U.S. fixed income markets increased in the third quarter, which muted returns for interest-rate sensitive segments of the fixed income market. Municipal bond returns were flat, and Treasuries posted negative returns of -0.3%. In contrast, credit-sensitive segments such as high yield and investment-grade corporate bonds fared well, increasing by 5.5% and 1.2%, respectively. As a result, the Barclays Aggregate Bond Index, which is a mixture of most bond market segments, increased by 0.5%.

The same cannot be said for international bonds, as yields continued to modestly decline across most of Europe in the third quarter due to European Central Bank (ECB) activity. Global credit did well because the ECB is also purchasing corporate bonds. Returns were also supported by modest currency appreciation relative to the dollar.

Finally, both domestic and international REIT returns were muted during the quarter and commodity returns turned negative for the first time this year.

Trade Politics and the Presidential Election

It's been a déjà vu for me every time I read an article about our presidential candidates' views on trade pacts.

Why? When I was shopping for a Ph.D. dissertation topic, the NAFTA (North American Free Trade Agreement) negotiations were about to get underway, and the potential impact of trade liberalization on the highly distorted and subsidized agricultural sectors in all three countries was a top concern. I jumped at the opportunity and spent the next two years building a model to show whoever would pay attention that agricultural producers in Mexico were going to get creamed if the government liberalized agricultural trade. But then a neat thing happened: right in the middle of my research, the Mexican government unilaterally removed all trade barriers on the country's second-largest crop, sorghum. But by the very next harvest, the government did a complete about-face, purchasing the entire



harvest to prevent prices from collapsing. It also reinstated seasonal tariffs on imports, domestic price controls and added a storage subsidy scheme. My dissertation became a treatise of what went wrong and why.

The “what went wrong” question is not hard to answer. Economists have long known (remember Adam Smith from Econ 101) that trade liberalization creates losers. But they also know that trade liberalization is still beneficial overall because expanding trade improves efficiency (i.e., enlarges the size of the pie). As such, the gains to the winners are, in principle, large enough to compensate the losers, and still leave everyone better off.

The problem seems to be that economists and politicians (like the Mexican government) like to emphasize the gains but downplay or ignore the costs. In the case of Mexico, domestic farmers revolted, closing roads and highways, and created such havoc that the government could not ignore them in the end. In the U.S., folks who have lost their jobs due to trade liberalization have been distressed for years. Some government policies have been implemented to try to ease the transition, but they have not been adequate. Now, those who lost out from trade dislocations are “revolting” by supporting Donald Trump.

Who are the losers in the U.S.?

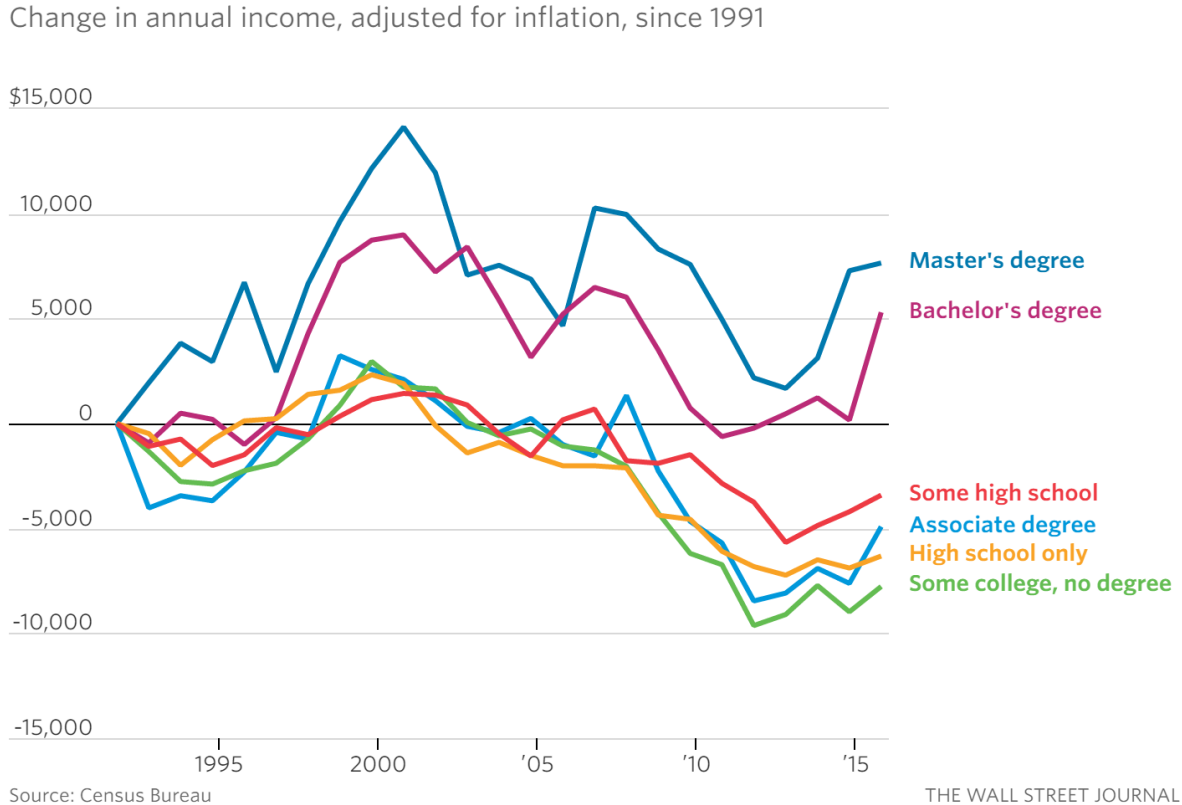
Who lost when trade was liberalized? The U.S. is a relatively productive, high-wage economy. As a result, its imports are concentrated in labor-intensive industries (e.g., clothing, low-end manufacturing), while its exports are concentrated in capital-intensive and knowledge-intensive industries (e.g., technology, financial services). Thus, U.S. trade flows tend to benefit highly skilled workers while hurting the unskilled.

A new report by Sentier Research released this month found that for high-school graduates, earnings per person declined 8.9% in real terms between 1996 and 2014.¹ For college graduates, per-person earnings rose 22.5% over the same period. Interestingly, Sentier found a similar trend in the previous 18-year period. Between 1978 and 1996, white male high-school graduates saw earnings fall by 10.7%, while incomes surged 30.4% for college graduates over the same span. Census data released last month (see Figure 2) reveals the same trend.

¹For more detail, see Sentier Research, Statistical Brief on Working Class Wages: 1996 and 2014, released October 6, 2016.



Figure 2: Annual Income by Degree Since 1991



Many of the “losers” fared even worse: they are the long-term unemployed. A new study by Alan Krueger, a Princeton economist, paints a dire picture. As of last month, 11.4% of men between the ages of 25 and 54 – or about 7 million men – were not in the labor force, meaning they aren’t even looking for work. According to the study, 44% said they took painkillers daily, whereas only 20% of employed men reported taking any painkillers.² Are they out of the labor force because they have pain or do they take painkillers as a result of being out of work and depressed? What we do know is that at the local level, employment falls at least one-for-one with jobs lost to trade, and that displaced workers are unlikely to move to seek new work.

To be fair, trade is not the only culprit. From 2000 to 2010, the U.S. lost some 5.6 million manufacturing jobs, by the government’s calculation. Only 700,000 of the job losses can be

² See “Millions of Men are Missing From the Job Market”, New York Times editorial, October 17, 2016.



explained by trade, according to an analysis by the Center for Business and Economic Research at Ball State University in Indiana. (A more recent study puts that number closer to 1 million.) The rest were casualties of automation or the result of tweaks to factory operations that enable more production with less labor.

Trade Adjustment Assistance (TAA), a government program started in 1962 by John F. Kennedy and expanded significantly a dozen years later, is supposed to support workers whose jobs are casualties of overseas competition. Yet a 2012 assessment of the program prepared for the Labor Department found that four years after completing training, only 37 percent of those trained were working in their targeted industries. Many of those enrolled had lower income than those who simply signed up for unemployment benefits and looked for other work.

The biggest problem is that the funding for TAA has been woefully inadequate, at just \$1700 per displaced worker in 2007. According to *The Economist* magazine, members of the OECD (i.e., mostly rich countries) set aside an average of 0.6% of GDP a year for “active labor-market policies” – job centers, retraining schemes and employment subsidies – to ease the transition. America only spends 0.1% of its GDP on those types of programs.³

Sadly, in my view neither presidential candidate is talking enough about a *well-targeted* tax and transfer scheme to help those most affected by trade liberalization, nor how to retroactively help those who have been hurt over the last couple of decades. Even President Obama is trying to force approval of the latest negotiated trade pacts – the Trans-Pacific Partnership (TPP) with Asian countries and the Trans-Atlantic Trade and Investment Partnership with Europe (TTIP) – without securing any agreement on further compensation of those who will be negatively affected.

Donald Trump’s advocacy for closing our borders, shipping out the 11 million or so undocumented workers and eliminating the H-1B visa program for highly skilled workers will raise wages, but at a huge societal cost of no economic growth. In fact, the U.S. economy is rapidly approaching full employment currently with the four-week moving average of new claims for unemployment falling to a 42-year low earlier this month. Trump is mad to think he can get the U.S. economy to grow by 4% annually in real terms (his stated goal) without sufficient people to create the growth in the first place.

³ For a good overview of the TAA, see Rosen, Howard. “Strengthening Trade Adjustment Assistance”, Policy Brief from the Peterson Institute for International Economics, January, 2008.



Hillary Clinton understands this very well, and she says she would like to expand the H-1B visa program and implement real immigration reform. She also has talked about reducing inequality with a broad tax and transfer scheme (e.g., tax the wealthy to fix our crumbling infrastructure), but much more should and can be done, such as a wholesale revamping of our technical and vocational education.

My bottom line is that I'm for trade liberalization, but it must be accompanied by more and better redistributive measures. Mexican farmers got their relief after taking to the streets and rioting – it should not have to come to that here.

Artemis Strategy

Artemis portfolios performed well again this quarter, as many of the structural overweights we favor, especially our overweight to small companies, outperformed. The only real drag on performance came from the municipal bonds, which had flat to slightly negative returns. The only move we made during the quarter was to eliminate our exposure to Treasury bonds (our exposure is indirect via a diversified bond index fund) in most client accounts. Treasuries did have a bad quarter as yields rose, likely in anticipation of the Federal Reserve's well-telegraphed desire to get in at least one interest rate increase this year.

Very soon we will implement two new moves in the portfolios. First, we are planning to reinstitute exposure to Treasury inflation-protected bonds (TIPS). The labor market continues to tighten and a consensus is forming that we are very near or at full employment. When the labor market becomes quite tight, modest declines in the unemployment rate can cause inflation to rise appreciably. Add to this even moderate fiscal expansion, and we could see a sharp jump in inflation. TIPS are a good inflation hedge, and the good news is that TIPS are still pretty cheap.

The second move we are planning to make is to further currency-hedge our international developed allocation. The dollar has already started to climb in anticipation of a rate hike in December, and the Japanese, in particular, are working hard to generate inflation and weaken the yen.