THE YEAR AHEAD

2017: A CHALLENGING YEAR AHEAD FOR PORTFOLIO ALLOCATION DECISIONS

February 2017

Surprising many investors and pundits alike, the S&P 500 posted a solid return for 2016, finishing the year up close to 10%. If investors never looked at their statements, one might be naïve to how much markets zigged and zagged throughout the year.

To mention a few:

- The S&P 500 was down -12% to start the year—the worst ever start to a calendar year—driven by tremors in Chinese equities and currency along with plummeting oil prices.
- The stock market also bounced back from the surprise of the Brexit vote and the uncertainty of the US election cycle, indicating a durable bull market.
- The benchmark US equity index completed its eighth consecutive positive year in the post-crisis environment. Incredibly, the S&P 500 has now delivered annualized returns of over 14% over this eight year period.
- Meanwhile, investors in many "alternative" investment strategies, such as hedge funds, suffered through mediocre relative performance exacerbated by high fees and negative press.

CAN WE EXPECT MORE OF THE SAME IN 2017?

At Altegris, we focus on selecting alternative and diversifying strategies that help advisors and investors create resilient portfolios. And we think that 2017 will be a year when portfolios need to be more resilient than ever. At the time of this writing, the inauguration of our 45th President is behind us and the so-called "Trump Rally" has taken a pause, awaiting some definitive delivery of many campaign promises.

Matt Osborne
Founder and Chief Investment Officer

Matt Osborne has more than 25 years of international business and financial market experience. As CIO of Altegris, he is responsible for product development and is co-portfolio manager of several Altegris mutual funds. He is a member of the Altegris Investment Committee, responsible for qualification, approval and ongoing review of all investment strategies and managers on the Altegris platform.

Prior to Altegris, Matt was Director of Research for the Managed Investments Division of Man Financial with responsibility for manager selection and research. Previously, Matt had a 12-year career with a preeminent family office in his native New Zealand. In his role as Investment Manager, he was responsible for formulating investment policies and implementing a global asset allocation program that specialized in alternative investment strategies such as hedge funds and managed futures. He also gained significant trading expertise in foreign currencies, stocks, fixed income, global futures and options.

Matt holds Series 3, 7, 24 and 63 licenses.

Predicting market direction and outcomes is notoriously difficult, if not impossible. Altegris agrees with Harry Markowitz's idea that diversification is indeed the one free lunch available to investors. As investors, we should never bet the farm on a single forecast or one expected outcome. But, however, we should form a base case economic and market view to help us make informed reallocation decisions that we believe will add value to our portfolios.

AT THE CORE OF THE ALTEGRIS BASE CASE FOR 2017: THE BEGINNING OF A TRANSITION FROM MONETARY TO FISCAL POLICY DOMINANCE

We believe that the impact of fiscal expansion along with tax and regulatory relief will create a genuine tailwind for the US economy and the slow grinding recovery may finally reach takeoff velocity. This is bullish for domestic equity valuations. The spread of populist movements will be the catalyst for increased fiscal spending in Europe as the electorates increasingly reject austerity. Politicians challenged by upcoming votes in France, Germany and the Netherlands will likely respond or face defeat. The evidence provided by the Italian banking crisis is that EU rules can be bent when necessary. Meanwhile, pressure is increasing in Japan to finally defeat deflation with a new round of fiscal stimulus. Taken together, we expect this fiscal tide change to be supportive of global growth. Stock markets in Europe and Japan remain below their highs and we are generally bullish, especially while their currencies are weaker versus the US dollar.

In our opinion, there are significant risks to contemplate:

1. **The US has clearly entered a rising rate cycle after eight years of zero interest rate policy.** Rising rates can negatively impact equity valuations, although less so at the beginning of the cycle. Equity valuations in the US are undoubtedly already high with a trailing 12 month p/e of 25 for the S&P500. Companies will need true earnings improvements to justify higher prices.

2. **Central banks in Europe are still experimenting with negative interest rates, despite evidence that the policy may, in fact, be deflationary.** Expect the BOJ and ECB to at least consider tapering their QE programs. As a result, 2017 may be the year for significantly more global interest rate volatility.

3. **The global debt burden totaled $152 trillion in 2015 and is still rising according to figures issued by the International Monetary Fund.** The figure includes debt held by governments, non-financial firms and households, and is equivalent to a record 225% of world GDP. The burden will continue to grow alongside fiscal expansion, further complicated by rising rates. The potential double bubbles of sovereign and private debt therefore remain increasingly susceptible to a "pop."

4. **Capital flight from China will keep pressure on their currency and reinforce state sponsored selling of US bonds to support the yuan, another factor driving US bond yields higher.** Keeping an eye on Chinese foreign reserves is a must. The latest data reveals a massive $3 trillion in reserves, yet that number is down almost 25% from mid-2014.

5. **A stronger US dollar** may pressure emerging market countries and companies with USD denominated debt on their balance sheets as this debt becomes more difficult to service and more expensive to refinance.

6. **Geopolitics just got more complex than ever with the uncertainty of a Trump administration** that appears determined to shake up the status quo.

Any of these risks has the potential to create substantial volatility and potentially derail financial markets. At a minimum, we expect that the transition from monetary to fiscal policy dominance here in the US will not be smooth, and volatility will increase across asset classes.

HOW SHOULD INVESTORS POSITION PORTFOLIOS?

We think that traditional fixed income will underperform and investors should consider reducing exposure. The risk reward is not there. The double whammy of rising rates and fiscal expansion should cause bond prices to fall further, finally confirming the end of the 35-year bull market for bonds. Once a new trend higher in bond yields is confirmed, expect acceleration as this "flow risk" supports additional rotation into other opportunities.

Diversification does not ensure profit or protect against loss in a positive or declining market.

Investors could reallocate the proceeds from traditional fixed income sales in a barbell fashion: at one end increase exposure to equities, including long-only, long/short, and private equity. Look for strategies that have a discernable edge and a history of consistent returns, and whose portfolio managers are conscious of how valuations are impacted by currencies and trade policy. At the other end of the barbell, increase exposure to diversifying strategies such as managed futures and global macro that have return streams that are typically uncorrelated with equity markets. View these strategies as portfolio risk tools: these aim to provide an element of protection for portfolios while still allowing investors to participate in what could be another year in an ongoing bull market for stocks. Meanwhile, the cost of access continues to fall as fee compression hits alternative investment providers. Investors benefit as these diversifying strategies are increasingly available without the drag of "2 and 20" fees.

We acknowledge that a bullish view is presently the consensus and the post-election rally has already priced in some favorable outcomes that are yet to play out. The likelihood of volatility to come will probably create a better opportunity to selectively add to long-only equity positions than the current level around Dow 20,000. However, some diversifying strategies, like managed futures, are already in a meaningful drawdown and investors could benefit from increasing diversification at a time when protective approaches appear out of favor. Remember: buy low, sell high.

OUR BOTTOM LINE

Fiscal stimulus could drive markets higher and be quite bullish for equities. That said, the potential for fatter tails (e.g. large market disruptions) appears to be higher now given geopolitical turmoil, the rise of populism and its leadership, and the massive amounts of global debt outstanding. Don't miss out on the upside potential of current markets, but look to protect against the downside. Build a resilient portfolio for the year ahead.

ABOUT ALTEGRIS

The Altegris group of affiliated companies is wholly-owned and controlled by (i) private equity funds managed by Aquiline Capital Partners LLC and its affiliates ("Aquiline"), and by Genstar Capital Management, LLC and its affiliates ("Genstar"), and (ii) certain senior management of Altegris and other affiliates. Established in 2005, Aquiline focuses its investments exclusively in the financial services industry. Established in 1988, Genstar focuses its investment efforts across a variety of industries and sectors, including financial services. The Altegris companies include Altegris Investments, Altegris Advisors, and Altegris Clearing Solutions.

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