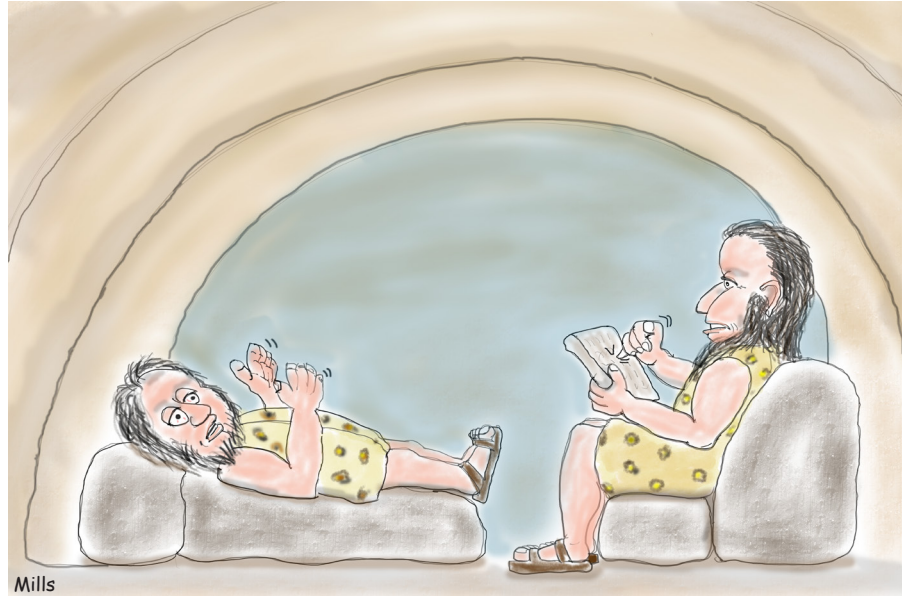


COUNTERPOINT

The Quarterly Commentary of Jurika, Mills & Keifer LLC



"First it was fire, and then the wheel, and now the kids today with their domestication of animals...things are just changing too fast".

THIRD QUARTER:
JULY, 2017

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*Changes &
Disconnects*

Current Strategy

Changes & Disconnects

Global financial markets continued their upward trajectory in the second quarter despite a steady flow of troubling geopolitical headlines and toxic twitterstorms.

For the time being, investors have decided to ignore the headlines and tweets in favor of economic fundamentals and the pursuit of return. The global economy is improving, corporate sales and profits are growing, and Central Banks around the world remain highly supportive of risk assets. Meanwhile savers are being penalized for keeping money in safe assets that offer little or no return.

Summary:

- Financial markets continue to rise, reflecting improving global economic growth.
- We are in the late innings of an extended economic growth cycle, marked by high valuation levels and growing complacency about risk.
- These conditions can persist for a while, especially when supported by Central banks, but risks are higher and expected returns are lower.
- Meanwhile, there are major currents of change at work, creating disconnects between peoples, politics, policy and reality. They will impact economic fundamentals in the years to come and need to be taken into account in portfolio positioning.
- We took steps to reduce overall portfolio risk during the last quarter and continue to balance investments targeted at areas of long-term growth with a core of defensive and alternative strategies.

We are likely in the late innings of an elongated economic cycle, marked by generally high valuation levels for risk assets including stocks, bonds and real estate. These conditions will likely persist for a while longer, barring some unpleasant surprise. We could easily see markets rise higher before the conditions that have been so supportive of them, start to reverse course, as they inevitably will.

In our last Commentary we cautioned against mixing politics and investing. But, there are a number of important changes and disconnects, both political and otherwise, that will have a real impact on economic and market fundamentals in the months and years to come. Unlike politics, fundamentals do matter to markets. We would like to call some of these out, particularly now while asset valuation levels are high and investors are becoming increasingly complacent about risk.

The Trump Agenda Disconnect:

The market surged in November on the expectation that, with control of the White House and both houses of Congress, the new administration should have no trouble moving on its agenda of corporate and individual tax reform, deregulation and infrastructure spending. Almost eight months later, there has been no progress on any of these fronts except for some lessening of regulations and a flurry of executive orders. Most of these have had a negligible economic impact.

Meanwhile, Congress has been consumed with trying to scuttle the Affordable Care Act and the President has been obsessed with a constant stream of personal distractions and attacks, none of which furthers the pro-growth

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economic agenda. He has also doubled-down on trade protectionism, immigration and a more isolationist foreign policy that is likely to hinder rather than foster economic growth and innovation. The irony is that President Trump might have enjoyed significant bipartisan support for tax reform and infrastructure investment.

Fortunately, the economy has been strong enough to support the markets despite the remarkable lack of political progress.

Immigration and Labor Disconnect:

The current national unemployment rate is now 4.4%. Coincidentally, the last times the unemployment rate reached these levels was at previous market peaks in 2007 and 2000 before that. Trough unemployment levels typically precede recessions.

Although there may be some areas of slack labor capacity, they are more the exception than the rule. Labor is tight around the country and wages are starting to rise. With a rising tide of baby boomers retiring each year, the U.S. needs a robust flow of legal immigrants to help offset the millions of workers leaving the labor force. If we start to see significant a

spike in wage inflation, the Federal Reserve will need to raise interest rates more aggressively. Higher interest rates typically lead to slower economic growth, including recessions, and lower asset prices.

In his most recent book *“Thank You For Being Late,”* Thomas Freidman argues that just as in nature where greater levels of biodiversity lead to healthier and more flourishing ecologies, greater levels of social diversity and integration lead to greater economic prosperity. The interchange of ideas and cultures stimulates higher levels of innovation. We can see this in practice in the U.S. where the most culturally diverse areas such as San Francisco, Los Angeles, Seattle, New York, and Boston also have the most vibrant and fastest growing economies. There is strength in diversity and more diverse parts of the country will likely enjoy higher levels of economic growth and prosperity going forward. Rather than demonizing immigration, we need to embrace it, strategically, as an important engine of growth and opportunity.

Political Disconnect:

There is a growing disconnect between politics and population, especially at the Federal Government. Thanks in part to redistricting, the Electoral College and influence of political action committees (PACs), political priorities have moved away from the center.

This disconnect has only gotten worse in recent decades as the political parties have been pulled increasingly to the far left and right. Centrist candidates from either party are endangered species, and the ability of Republicans and Democrats to find common ground to govern

effectively for the common good is becoming ever more challenging.

As a result, we are seeing state and local governments, as well as corporations moving in to fill the void of leadership, especially in areas like environmental policy, healthcare and social issues.

Environmental Disconnect:

Beyond the debate of what causes climate change, is the fact that the global climate is warming with much more immediate and dramatic implications than people realize.

Average increases in global temperatures or sea-level readings don't really tell the whole story. The actual increase in temperatures in parts of sub Saharan Africa and the Middle East have turned vast expanses of formerly arable land into desert, threatening the lives and livelihoods of the people who live there. This, in turn has led to political and social unrest, and mass migration of refugees to northern Africa and Europe. Many of these refugees are men who become easy and willing recruits for extremist groups like Boko Haram and ISIL.

The most significant and immediate impact of climate change will not be warmer winters in Washington DC, but rather a spreading wave of geopolitical instability elsewhere in the world.

It is hard to solve a problem if we don't acknowledge and address its root causes.

Healthcare Disconnect:

It turns out that Healthcare is complicated, especially if you ignore basic math. You cannot

have low overall health insurance rates that cover pre-existing conditions, without a broad population of young and healthy people to offset the insurance risk of older and less healthy people. That's the way that insurance works: the premiums of the many cover the risks of the few. Young people are not immune to getting injured and sick and if you allow them to opt out of the system, the premiums for older and sick people become unaffordable.

The Republican plan to repeal and replace the Affordable Care Act has hit the wall of this reality as well as conflicting political priorities between factions within the party. If they can't find a suitable replacement now, the idea that they might repeal the existing system now and find a replacement later seems problematical. It would likely cause millions of people to lose healthcare coverage, and create huge uncertainty for the health care industry, driving insurance rates higher for everyone in the process.

Healthcare is not only complicated, it is also at the center of, and out-of-step with major currents of change. The idea of companies providing health insurance to employees worked a lot better when most people worked for a single company for their entire career. Today, workers change jobs frequently and may have extended periods where they have no single employer. Healthcare needs to take this new reality into account.

Meanwhile, as previously noted, the population is aging and as people get older, they require more healthcare services.

Finally, the industry is experiencing rapid innovation and disruption, especially in areas

like life sciences and medical technology, as well as new and much more efficient ways to provide care.

Innovation Disconnect:

Wayne Gretzky famously said, "skate to where the puck is going to be, not where it is." If anything, many of the Administration's current objectives seem focused on skating to where the puck was, in the distant past.

In our April 2014 Commentary entitled "Networked Knowledge," we talked about how the pace of innovation is growing at an exponential rate. Human beings tend to look at the world linearly, and governments tend to have trouble keeping up with linear change, let alone exponential change.

The idea of "making America great again" by reigniting an industrial revolution in this country with millions of new manufacturing jobs may sound appealingly nostalgic, but it is disconnected from current and future reality.

From a business standpoint, America is already "great" and is leading the charge into the future, creating new technologies and companies, reshaping entire industries and economies in the process. The entrepreneurial and pioneering spirit of American enterprise is flourishing, but it is rooted in a new reality.

This new reality is centered around knowledge and information, and the networking together of almost everyone and almost everything, via "the cloud."

And it is evolving quickly. According to the research firm IHS/Markit, there were 17.7

billion devices connected to the internet last year. By 2025, this number will have grown to over 75 billion devices. We are in the early days of understanding and harnessing the potential of combining people, knowledge, and devices with massive computing power and artificial intelligence but we already see its impact in our lives and our work.

The traditional work in factories of today and the future as well as many other manual jobs will be done by robots. Similarly, many “white collar” and other service jobs will be performed by software. Autonomous vehicles and drones will change the nature of transportation. Many traditional jobs will be lost and many new types of jobs will be created, but they will likely require new skills and new flexibility.

We need to be preparing our workers for this new reality and skating economic policy towards where the puck is going to be, not where it was. And the puck is moving faster every day.

Investment Disconnect:

The final disconnect that we mentioned at the outset is the potential disconnect between current asset prices and fundamentals.

Currently, asset prices are supported by reasonably good economic growth, strong corporate profits and very low interest rates. They are also supported by a growing complacency about geopolitical risks. After seeing the market defy expectations and rise in the wake of the Brexit vote and the Trump victory, investors may be starting to believe that the market is immune to external shocks and that every headline-inspired dip is a buying

opportunity. This is a sentiment that can change very quickly, especially if the economy starts to slow, and/or if interest rates start to rise.

The Federal Reserve has reversed course and is now starting to raise short-term interest rates. It is also removing itself, step-by-step, as a marginal buyer of long-term bonds. The European and Japanese Central Banks have not yet started to follow suit, and this may help to keep U.S. interest rates low for now. But, if we start to see inflation pick up, interest rates could rise rapidly. A rapid increase in rates would tend to slow economic growth and cause stocks, bonds, and other risk assets to get repriced lower.

Investment Conclusions:

The world is a lot more dynamic, complex and connected than it seems on television. The Global economy is also a lot more diverse and resilient than the headlines suggest. But there are major currents of change at work, and the rate of change is accelerating, creating ever greater disconnects between peoples, politics, policy and reality. These disconnects threaten economic prosperity and geopolitical stability if they are not addressed.

We think that it is critical that investment portfolios are managed with a forward-looking view of the world that takes these changes and disconnects into account.

Currently, global growth is growing and picking up, especially in areas like Europe and the Emerging market economies. For the first time in five years, non-U.S. stocks are outperforming U.S. stocks.

Valuation levels are high and it remains to be seen if economic fundamentals will rise to support them. Valuation levels, by themselves, are not a good predictor of market direction. But when valuation levels are high, investment opportunities are fewer and less compelling, expected returns are lower, and markets are more vulnerable to nasty surprises.

For this reason, we took a few steps last quarter to reduce overall risk in client portfolios, increasing our allocation to alternative strategies.

Meanwhile, we continue to invest with a global focus, balancing investments targeted towards areas of long-term growth and innovation, such as technology, life sciences and the developing world, with more defensive equity, alternative and bond strategies to mitigate volatility and risk.

“We need to be preparing our workers for this new reality and skating economic policy towards where the puck is going to be, not where it was. And the puck is moving faster every day.”

As always, we welcome your comments and questions.

Jurika, Mills & Keifer, LLC
July, 2017



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Our firm is built on a core set of values and investment principles that have been central to our identity and success for over 30 years.

Our objective is to preserve and build the purchasing power of our clients' capital over time through forward-looking investment management and smart financial planning and counsel.

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