

---

## THE NEXT MACRO SAGA

---

Market Review    **FEBRUARY 2018**

Interest rates made big moves higher in western financial markets last month. The benchmark German Bund yield, a staple interest rate for the European Union, spent most of 2016 below 0.5%. It is now closer to 0.7% with momentum to the upside. The benchmark US Treasury yield is now about 17% higher from December's close and currently trades around 2.8%.

At the time of this writing, global stock market prices held their ground as borrowing costs rose in January. US stocks actually made meaningful gains last month. European stocks, however, were mixed. Stock markets in Europe's most developed economies ended January mostly flat. Much better stock market performance was found in smaller European economies. A new cycle may be on the cusp and it may favor smaller European economies and stock markets.

Small economies of Europe have stood in troubled waters for quite some time now. As a result, their stock markets became neglected. Perhaps enough deleveraging and purging of toxic assets has come to pass, and smaller European economies stand ready for growth. The global recovery of larger economies may also provide the tailwinds needed for the smaller ones. Consequentially, small and emerging economy markets outperformed in January.

However, western developed economies shouldn't be discounted just yet. The US, for example, currently has a tight labor market, mostly stable prices, and higher household net worth. In fact, another 200,000 jobs were added to the US economy in January. A very good number indeed. Also, US wages are up 2.9% over the past year. Fundamental factors are hotter inside the US, as well as outside of it. This could be what the global bond market is signaling.

A potential new cycle could have investors speaking of a risk long forgotten, an inflationary spike in the US. Since the Great Financial Crisis of 2008, the US government has built a debt bubble. The public federal debt balance started near 65% of annual GDP in 2008. It is now over 100%. Inconsequentially, foreign bond demand was strong enough in the past to sustain the debt run-up. If foreign bond demand were to dry up today

**"All else equal, growth based on borrowed money instead of growth based on production produces unnecessary inflation."**

and US debt continues to build, higher inflation in the US is possible.

The US Federal Reserve (Fed) explicitly said higher inflation is expected in their comments following their first meeting of the year. Even so, the Fed voted to hold the upper-end of the target interest rate unchanged at 1.5%. Still, three rate increases are expected in 2018, which could bring the upper-end closer to 2.25%.

To manage the mandate and prevent the economy from overheating, the Fed has begun withdrawing liquidity from financial and banking markets. In addition, the Fed could be losing sleep over the US Treasury's readiness to grow GDP by borrowing more money. For instance, the US Treasury recently announced that it would be increasing the size of its auctions to finance future budget deficits. This announcement came at a time when the US Treasury asked Congress to raise the government's borrowing limit.

All else equal, growth based on borrowed money instead of growth based on production produces unnecessary inflation. And, once the economic binge on debt goes too far, inflation becomes the self-correcting tool of an overutilized economy. The Fed has esoteric knowledge of the destructive forces that unwanted inflation has on businesses and households, which is why they sound more hawkish today (policy of increasing interest rates).

Today's global interest rates could only be a temporary move. Then again, financial markets could be preparing for the next leg in the economic cycle. Should it be the latter, investors can expect higher volatility as large institutional funds are forced to rebalance. Smaller investors would also be wise to stick to a sound target asset allocation plan suitable for their needs.

## Market Movers

Global stock markets and interest rates rose in January, and stock market volatility picked up as well. The US dollar fell last month against the Euro and Sterling Pound. Are financial markets signaling a contemporaneous change in the economic cycle? Some feel that the public federal debt balance has gotten too large for a developed economy such as the US. Further deficit growth poses an economic risk that could spill over into financial markets. Our Core Allocation portfolios can help mitigate idiosyncratic financial market risks through the diverse set of investments held within the allocation. Last month, the Core Allocation portfolios made gains and generally tracked the benchmark, the Morningstar World Allocation category average. Inside the portfolios, asset allocations that appreciate with economic growth performed best, while interest rate sensitive securities underperformed.

Asset Categories	Monthly	YTD
US STOCKS	3.69%	3.69%
FOREIGN STOCKS	5.57%	5.57%
US BONDS	-0.23%	-0.23%
FOREIGN BONDS	1.08%	1.08%
HARD ASSETS	1.48%	1.48%
HYBRIDS	0.91%	0.91%

\*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING JANUARY 31, 2018.



**US STOCKS** rose in January posting a category average total return of about 3.7%. Large Cap, Mid-Cap, and Small Cap performance ranked in sequential order. Companies are currently reporting fourth-quarter earnings. The results are matching analysts' expectations, a good thing for security prices. The Core Allocation portfolios over-weighted US equity at the beginning of the year, which allowed the portfolios to get a jump on the benchmark.



**FOREIGN STOCKS** also gained in January. The category average total return was approximately 5.5%. Emerging market stock performance was the best in this category with total returns above 7%. Developed country stock markets were propped up by smaller economies. The Core Allocation portfolios selected emerging markets to outperform in the foreign allocation and the portfolios benefited from that conviction.



**US BOND** performance was less than spectacular in January. The US bond category average was weighed down by government bonds. Government interest costs rose last month. Corporate bonds also slid given corporate yields correlate to government yields. The resilience of stocks and strong corporate profits, however, allowed high-yield bonds to escape the sell-off. The US bond allocation was recently reduced in the Core Allocation portfolios which benefited the portfolios in January.



**FOREIGN BONDS** made some gains last month. The category average total return was up just over 1%. World bond funds led the category, but emerging market debt trailed not too far behind. The Core Allocations held emerging market bond exposure steady this year recognizing its competitive yield advantage in the global bond environment.



**HARD ASSET** prices rose in January. Precious metals and gold led the category's total return. The category's total return ended January close to 1.5%. US real-estate was a drag on the category's total return. US real-estate retreated due to rising domestic debt costs. The Core Allocation portfolios made a generous allocation to hard assets this year due to the height of equities and also the risks facing bond markets.



**HYBRIDS** made a modest gain of about 1% in January. Convertible debt performed well. However, preferred stock was a drag on the category average. Hybrids should continue to do well with rising equity markets. Should stock markets come under pressure, however, convertible debt and preferred stock can help provide some protection on the downside.

Investment advisory services offered through Clear Creek Advisors LLC, a State of Colorado Registered Investment Advisor. Subadvisory services are provided by Advisory Alpha LLC, a SEC Registered Investment Advisor.

Registration with the SEC or state does not constitute an endorsement of the firm by regulators, nor does it indicate that the adviser has attained a particular level of skill or ability. This content is for informational purposes only and does not intend to make an offer or solicitation for sale or purchase of any securities. Investing involves risk, including the potential loss of principal. No investment strategy, such as asset allocation or diversification, can guarantee a profit or protect against loss in periods of declining values. All investment strategies involve risk and have the potential for profit or loss. Changes in investment strategies, contributions or withdrawals, and economic conditions may materially affect the performance of your portfolio. There are no assurances that a portfolio will match or outperform any particular benchmark. The performance information presented in the asset category section of this report is based on equal-weighted averages of the following Morningstar Categories: US Stocks (US Fund Large Blend, US Fund Mid-Cap Blend, US Fund Small-Blend), Foreign Stocks (US Fund Foreign Large Blend, US Fund Foreign Small/Mid Blend, US Fund Diversified Emerging Mkts), US Bonds (US Fund Intermediate Government, US Fund Inflation-Protected Bond, US Fund Corporate Bond, US Fund High Yield Bond, US Fund Bank Loan), Foreign Bonds (US Fund World Bond, US Fund Emerging Markets Bond), Hard Assets (US Fund Commodities Precious Metals, US Fund Commodities Energy, US Fund Global Real Estate, US Fund Real Estate), Hybrid Assets (US Fund Convertibles, US Fund Preferred Stock). © 2017 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. Version 11.3.2017.