January 28, 2017

Since Trump's presidential victory in October, there is excitement and hope on the one hand and fear and disbelief on the other. The way forward has not been so uncertain for some time. The uncertainty and confusion is not only due to the change in the administration but that change is happening at breakneck speed and broad. Moreover, what has been deemed as settled and reliable are being turned upside down and questioned. It is a form of sensory overload that brings more questions than answers. Governance may be going through a period of trial by error or trial by fire. The single word that investment professionals and macro economists can agree on is uncertainty.

- **Steady and Upwards** – The U.S. economy remains on solid footings with consumers continuing to lead the expansion. Labor economy remains a bright spot with steady new job creation and lowering unemployment trends; even though some slack and low labor participation rate remain. Job opening is back to pre-crisis high.

- **Disinflation to Reflation** - Healthy signs of wage and job growth-led consumer demand will likely push inflation higher, and the risk of disinflation and deflation may be behind us. There are also signs of global reflation. Depending on the timing, scale and scope of U.S. fiscal and structural (tax and deregulation) changes, there could be a greater inflation surprise to the upside that would force interest rates to rise much faster and lead to market corrections, fixed income losses and ultimately recession in the next few years - more uncertainty.

- **Printing Money to Borrowing** – The U.S. has solely relied on the monetary policy since the Great Recession to stabilize and push the economy forward. The effectiveness of extraordinary monetary policies is ending and the much needed addition of the fiscal policy and structural reform may be around the corner as promised by the Trump Administration. Even though the legislative branch is controlled by Republicans, there is no certainty that Trump will get his way as the year goes on. Trump promises to "drain the swamp", and it is the same swamp that he needs to bath in to move forward – more uncertainty.

- **Status Quo to Disruption** – Donald Trump was elected to bring changes to the political system and to the country. He has demonstrated a new brand of leadership that is uncomfortable for many. Trump is a lightning rod for change, may it result in creation or destruction – more uncertainty.

- **Order to New Order** - Political risk is rising with unknowable outcome and effect. Brexit and the election of Donald Trump are just two 2016 examples of rising Right Wing populism and economic nationalism that the world has not witnessed for generations. Geopolitical tension and breakdown of reliable alliances are on the rise which impacts financial markets. The challenge is that an inward looking America will, in the long run, be negative to our and the global economy and, at the same time, create a political vacuum for China and Russia to fill. The U.S. could be giving up its supremacy and influence at a time when Trump is trying to Make America Great Again – more uncertainty.

- **Globalization to De-globalization** —Globalization over the past thirty years has lifted millions from poverty and raised living standards globally. It has been net positive for the world, but it also displaced jobs and security for many as the economic pie shifted. This gave rise to income and wealth inequality globally at a time when machines are beginning to compete with humans for jobs. Although understandable and, perhaps, necessary to remind leaders that change is needed, Populism is one manifestation of the frustration and push back against the status quo, but the answers are often reaching back to the past instead of leaping forward to the future — more uncertainty.

- **The Double Edged Dollar** — Trump's fiscal and structural policy success will push the dollar stronger further which would over time dampen our exports (and cause inflation). This would further support Trump's narrative of unfair trade (increasing trade deficit) and strengthening his case for economic nationalism or de-globalization — more uncertainty.

The Year of the Cocky Rooster

Today the Chinese lunar calendar marks the beginning of the year 4715 by retiring the Year of the Fire Monkey and welcoming the Year of the Fire Rooster. A giant rooster, commissioned by the mall owner, is in front of a Taiyuan shopping mall, located in Shanxi Province of China. The statue is a caricature of Donald Trump and is now the mall's mascot (even though Donald Trump was born in the Year of the Dog). A Rooster is typically associated with the characters of pride and to fight with unyielding determination. On the 20th, we marked the inauguration of Donald Trump as the 45^{th} President of the United States of America, truly a monumental event that ushers in four, if not eight, years of nationalism in America.

The New President

Since the Global Financial Crisis ("GFC"), the world economy has been growing at a below trend speed with stubbornly high unemployment and underemployment rates. The spending in the go-go years contributed to significant leverage and private debt which led to misallocation of capital and created excess capacity. Global central banks, through unconventional monetary policies [zero (ZIRP) and negative (NIRP) interest rates and large scale asset purchases under quantitative easing], dampened volatility and promoted risk taking in hopes of sparking the "animal spirit" back into the economy. We witnessed an extraordinary expansion of the public balance sheet (i.e. mutualizing private debt into public debt) which increased macro liquidity while formulating new regulations and policies that dampened the transmission mechanisms for lending and market liquidity.

Right after the Trump victory in October, expectations about the future have altered and assumptions about the present have been brought into question. The slogan for the Donald Trump presidential campaign was "Make America Great Again". To that end, Candidate Trump made a number of promises loosely grouped into the following six broad categories, and during his first week in office, he has been busy fulfilling them:

1. **Structural Reform** – reduce income taxes, increase fiscal spending/deficit, and repeal regulations
2. **De-globalization/Nationalism** – under the banner of "America First" and in the name of fair trade, withdraw from the Trans-Pacific Partnership (TPP); renegotiate NAFTA; impose tariffs on China and Mexico; label China as a currency manipulator; discourage companies from relocating to other countries; impose taxes on imports; bring manufacturing jobs back to America; etc.
3. **Deregulation** – suggest that 70 percent of federal regulations "can go" and suggest a moratorium on new rules; repeal and replace Obamacare; etc.
4. **Immigration and Security Reform** – "Build That Wall" and make Mexico pay for it; temporarily ban Muslims from entering the U.S.; and suspend immigration from terror-prone regions; under the "Make America Safe Again" slogan, restore law and order and expel criminal illegal immigrants
5. **Redefining Security Alliance** – question the entire post Second World War alliance such as the relevance of NATO and the United Nations while embracing

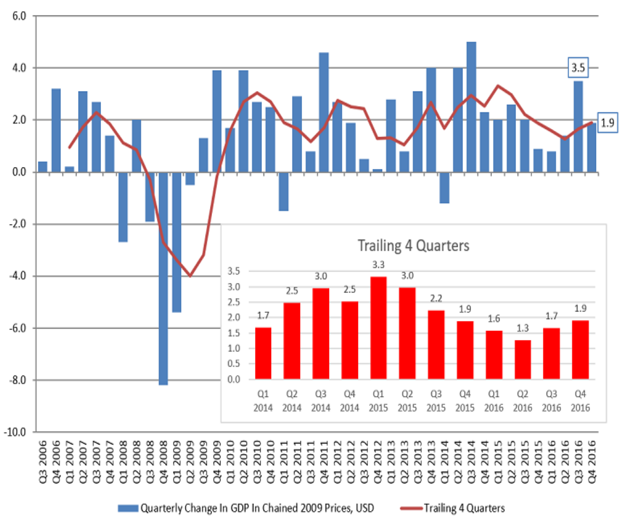
Russia, and look for more financial support and self-reliance from the Middle East and Japan

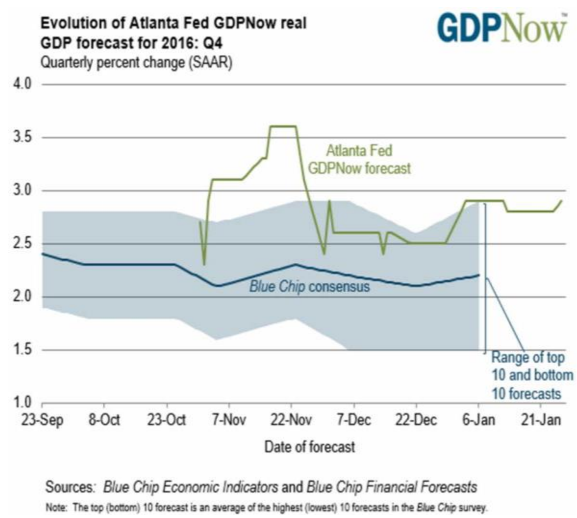
6. **Terrorism and Defense** -"Make America Great Again" would eliminate ISIS and radical Islam and substantially expand the military.

Before we consider the possible impact some of these proposed themes, positons and policies may have on the U.S. economy, let's review the four broad factors that the Federal Reserve focuses on when contemplating rate normalization: GDP, Employment, Inflation and Financial Markets (financial conditions).

The Economy

The third estimate for the third quarter 2016 GDP came in at 3.5% and revised the second quarter GDP up to 1.4% while the advance estimate for the 4th quarter released yesterday was a disappointing 1.9%. For the year of 2016, the annual real GDP growth rate stands at an uninspiring 1.9%. The U.S. economy remains stuck in a low growth environment. According to the Atlanta Federal Reserve Bank GDPNow real time estimate, the 4th quarter real GDP is still projected at 2.9% annualized rate, as of 01-27.



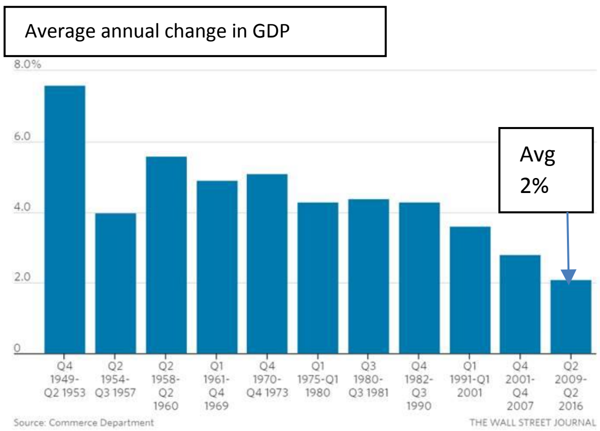


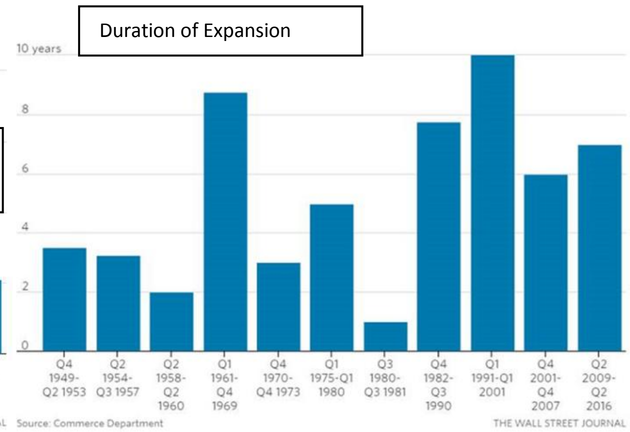
The Blue Chip Economic Forecast places a range between 1.5% and 2.9% for the final quarter. The advance estimate is notoriously inaccurate and is subject to a number of revisions. It is entirely possible that the 1.9% real GDP estimate is revised upward closer to the 2.2% consensus level. Even if the final fourth quarter GDP is revised up to 2.2%, the real GDP would only be at 2% for 2016.

Personal Consumption Expenditures, i.e. consumers, has been the largest contributor to the ongoing economic recovery (combining durable goods, nondurable goods and services). What have been missing are government spending (primarily federal) - i.e. fiscal expansion and Gross Private Domestic Investment (i.e. capital expenditures by companies). It is understandable that, after authorizing $787 billion under the American Recovery and Reinvestment Act of 2009 to stabilize and stimulate the economy, the U.S. Congress has been reluctant to follow up with more fiscal spending or debt creation. Monetary expansion through the Federal Reserve became the sole alternative to foster economic recovery and growth. This has been a blunt instrument to stimulate the economy and has reached its limit of desired effectiveness. The post Great

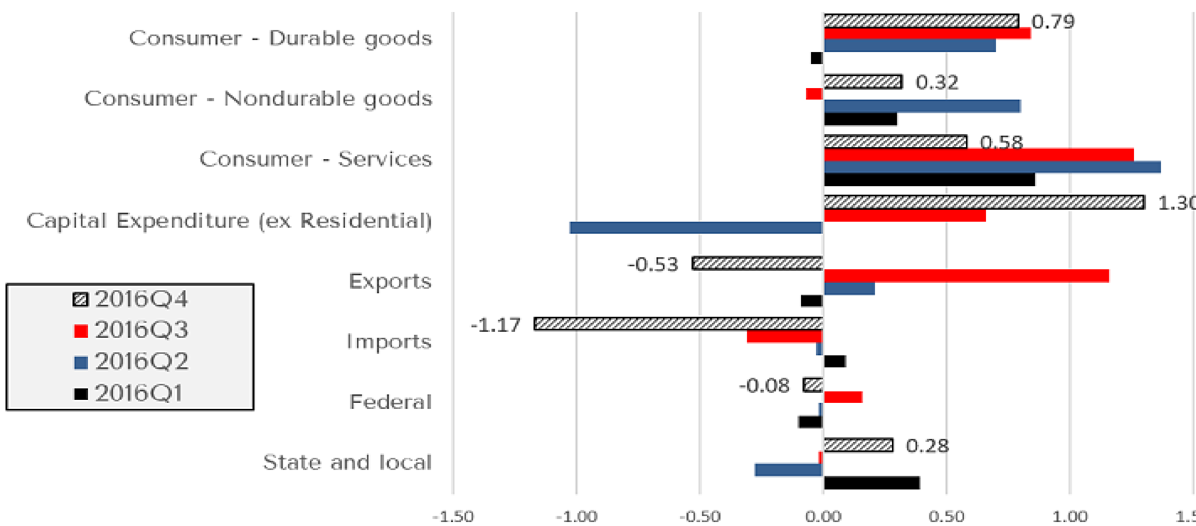
Recession slow growth environment, often referred to as the New Normal, has given little reason for meaningful capital expenditure and investment by corporate America.

This has been the slowest economic recovery since World War II. The prior expansion, from 2001 through 2007, was the only other business cycle of the past eleven when the economy didn't grow at least an average of 3% per year. Perhaps, due to the weak recovery, the current economic expansion is the third longest since World War II.



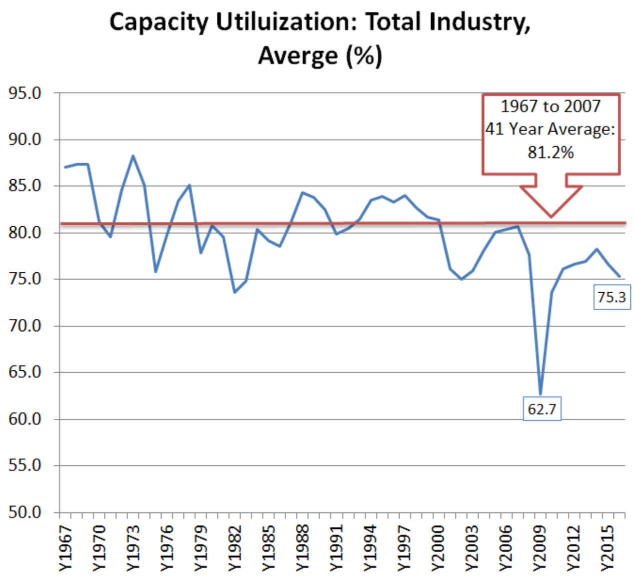


According to the Bureau of Labor Statistics (BLS), for the fourth quarter, the trailing contributors to percentage changes in real GDP are as follows:



The data indicates that the consumer remains the driving force in sustaining the economic expansion. The long awaited private capital expenditure (excluding residential construction) is now a net contributor, and hopefully this is the beginning of the much needed trend. But export, import and federal government (fiscal) spending remain detractors to the economy. This too may be changing if the new administration, working with a single party Congress, is able to implement some form of meaningful fiscal stimulus and tax reform.

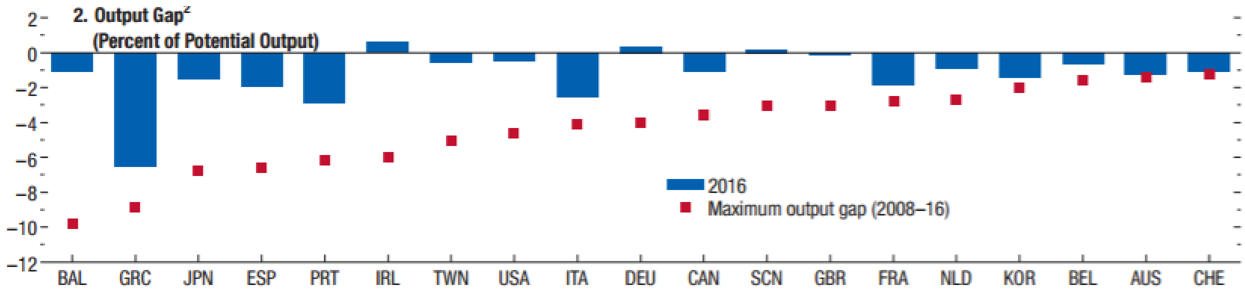
Industrial capacity utilization is one indicator that offers a feel for the tightness of the economy. The higher the capacity utilization rate, the greater the need for investment and pressure on inflation. In a global economy, industrial capacity should be viewed within the world context and not limited to a single country. According to the latest Industrial Production and Capacity Utilization data from the Federal Reserve, as of January 18, 2017, industrial production rose 0.8% in December after falling 0.7% in November. For the fourth quarter as a whole, the index slipped 0.6% at an annual rate. In December, manufacturing output moved up 0.2% and mining output was unchanged.



Using Federal Reserve historical data, the average total industry capacity utilization for the U.S. is 75.3% in December. The average capacity utilization from 1967 through 2007 is 81.2%. Even if the years since the Great Recession are included, the average is 80.08 during the 50-year period ending 2016. This underutilization or over capacity phenomenon is not unique to the U.S. The global economy, due to a number of factors, is also experiencing overcapacity challenges which dampen price and inflation. Unless world growth picks up meaningfully and is sustained, private capacity expenditure is likely to remain weak. This would continue to put pressure on inflation. One possible scenario would be if the Trump administration takes the path of nationalism and installs border taxes and tariffs. As Donald Trump has repeatedly threatened to do so to bring manufacturing and jobs back to America, capacity utilization could improve along with the domestic economy in the short term. But to unwind the entrenched and often efficient global supply chain built over multi-decades would take time, and not to mention, it would be inflationary and extremely disruptive on the global scale.

The IMF publishes annually, in its World Economic Outlook (WEO), the global output gap measures. The output gap is an economic measure of the difference between the actual output of an economy and its potential output. Potential output is the maximum amount of goods and services an economy can turn out when it is most efficient—that is, at full capacity. Often, potential output is referred to as the production capacity of the economy. According to the 2016 WEO[1], there remains significant slack in most economies and this places down pressure on inflation and the need for capital expenditure.

[1] https://www.imf.org/external/pubs/ft/weo/2016/02/pdf/text.pdf

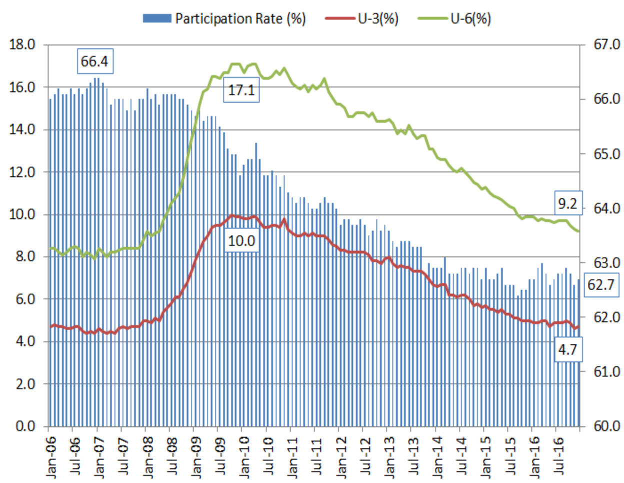


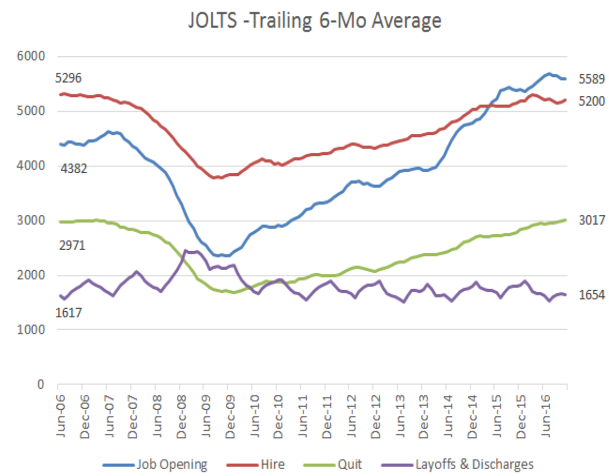
Employment

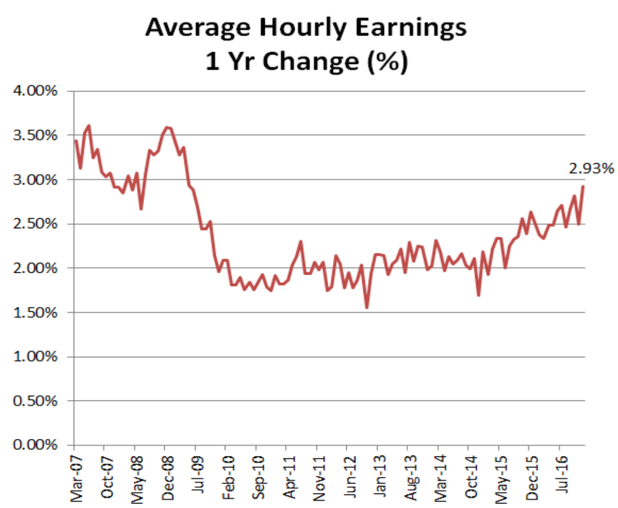
According to the January 6, 2017, Bureau of Labor Statistics (BLS) Employment Situation Summary[2], the total nonfarm payroll employment rose by 156,000 in December, while the unemployment rate, at 4.7 percent, and the number of unemployed persons, at 7.5 million, changed little in December. According to the January 10, 2017, BLS JOLTS report[3], the number of job openings was at 5.5 million on the last business day of November, hires and separations at 5.2 million and 5.0 million, respectively, with the quits rate at 2.1 percent and the layoffs and discharges rate at 1.1 percent all remaining the same as in October.

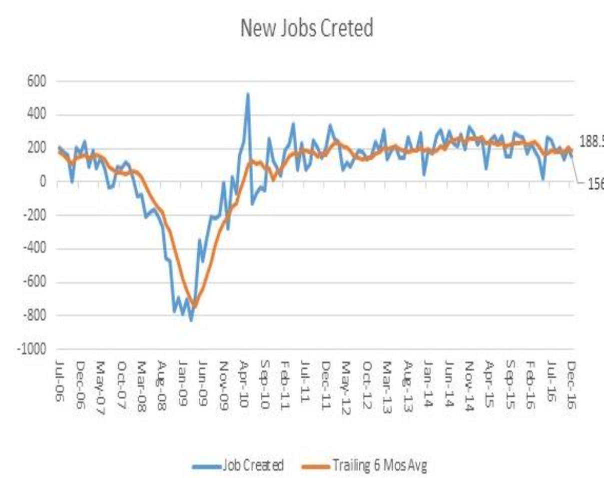
Although the U3 number is at a post Great Recession low of 4.7%, the falling U6 rate at 9.2% remains above pre-crisis level. This is also happening at a time when the participation rate remains at a sticky 62.7%. The latest rolling 6-moth (removing the monthly volatility) JOLTS data (job opening, hire, quit and layoffs & discharge rates) paints a positive picture. The number of job openings continues to climb and has exceeded the pre-crisis level. The quit rate is also higher. This means that employees have gained enough confidence to quit their current position as they deem new jobs to be readily available. The tapering hire rate and the 2.93% average hourly earnings increase over the trailing 12-month basis suggest that the labor market is tightening, and the low participation rate and the sticky high U-6 rate may be more structural and the labor slack is fast disappearing. This is further evidence that there may be a widening skill gap and that we have exceeded or are at NAIRU (non-accelerating inflation rate of unemployment which is the rate below which wage inflation rises). Wages will likely continue their ascent which will contribute to the demand-pull inflation.

[2] https://www.bls.gov/news.release/empsit.nr0.htm
[3] https://www.bls.gov/news.release/pdf/jolts.pdf







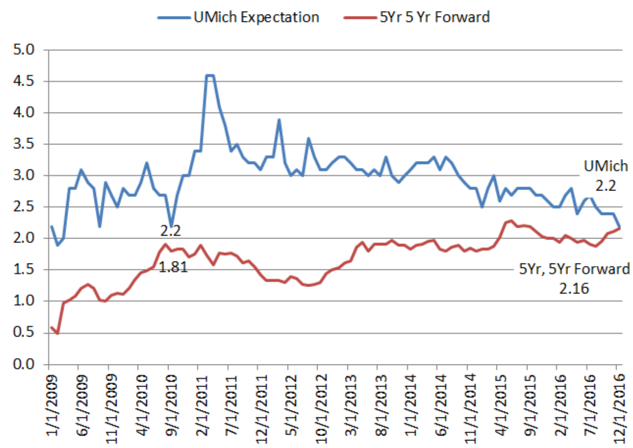


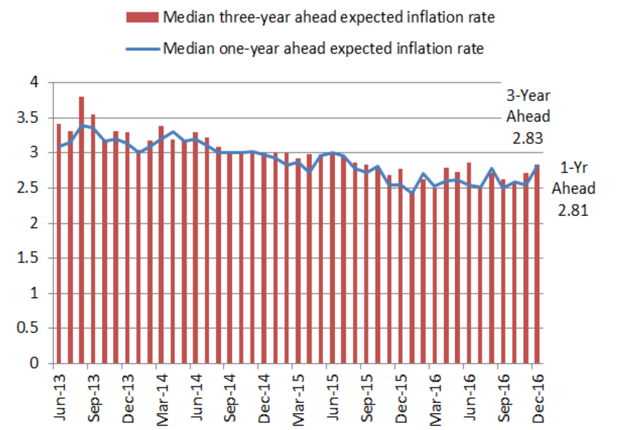
This is happening before any impact that may be derived from the Trump Administration's pro-growth policies. As such, we expect the U-3 rate to continue its downward trend a bit more going forward even though we do not expect new jobs will be at the current rate of 156,000 per month or a trailing 6-month average of 188,500. Further we expect wages to continue to increase as the labor slack continues to disappear and places pressure on inflation.

Inflation

Inflation has been and is on the rise. As mentioned earlier, with real wage finally growing, it will lead to a demand-pull inflation.

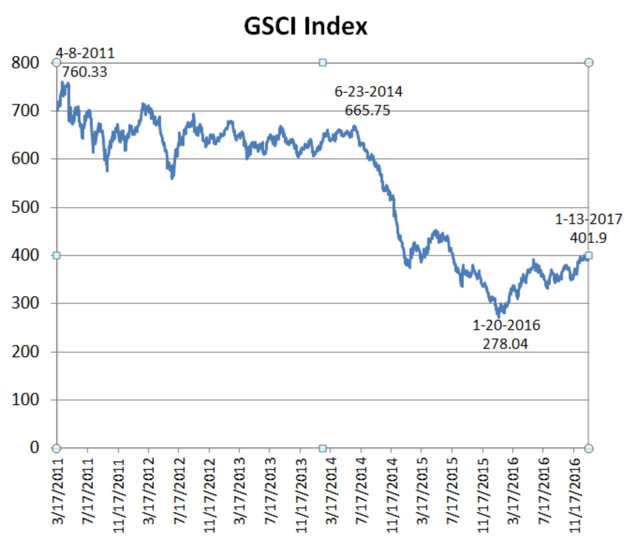
It is expectation that moves inflation. With the 12-1-2016 survey-based University of Michigan Consumer Inflation Expectation at 2.16% and the 01-23-2017 5-year, 5-year forward market participant based Inflation Expectation Rate at 2.81%, both are above 2%.

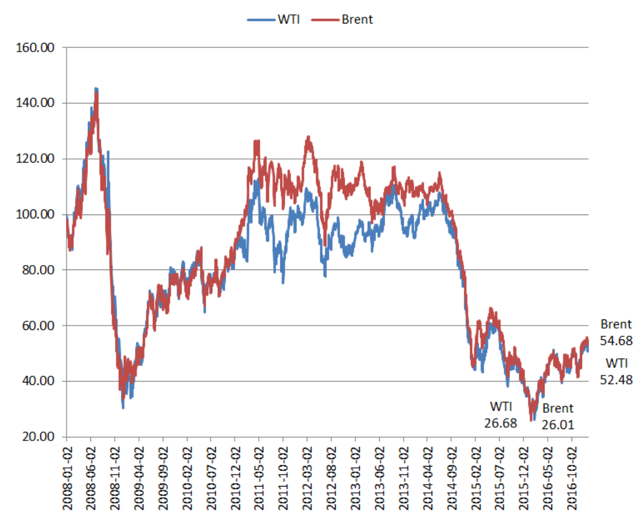




Source: New York Fed's *Survey of Consumer Expectations*

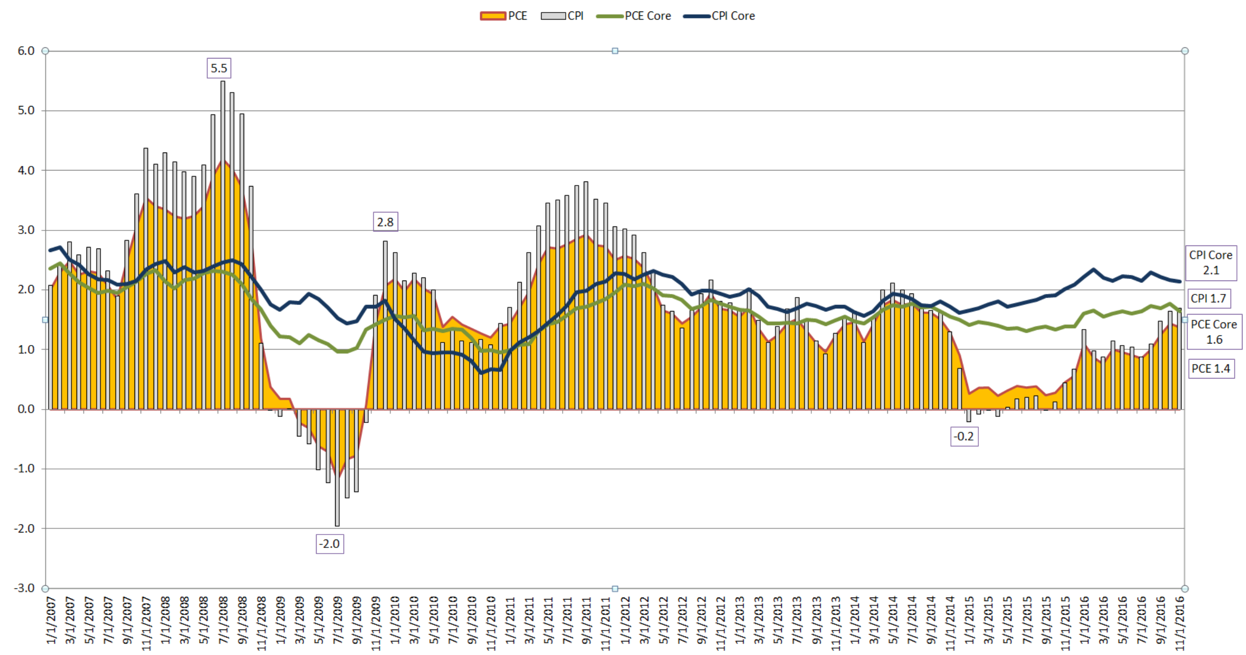
The NY Federal Reserve Survey of Consumer Expectation[4] for Inflation also shows a similar upward trend for 1- and 3-year periods with the 1-year ahead rate at 2.81% and 3-year ahead rate of 2.83%. These are encouraging signs for the FOMC as the Committee has been waiting for more evidence that U.S. inflation is firmly on track towards the 2% target and the probability of deflation to diminish before taking more aggressive rate normalization moves.





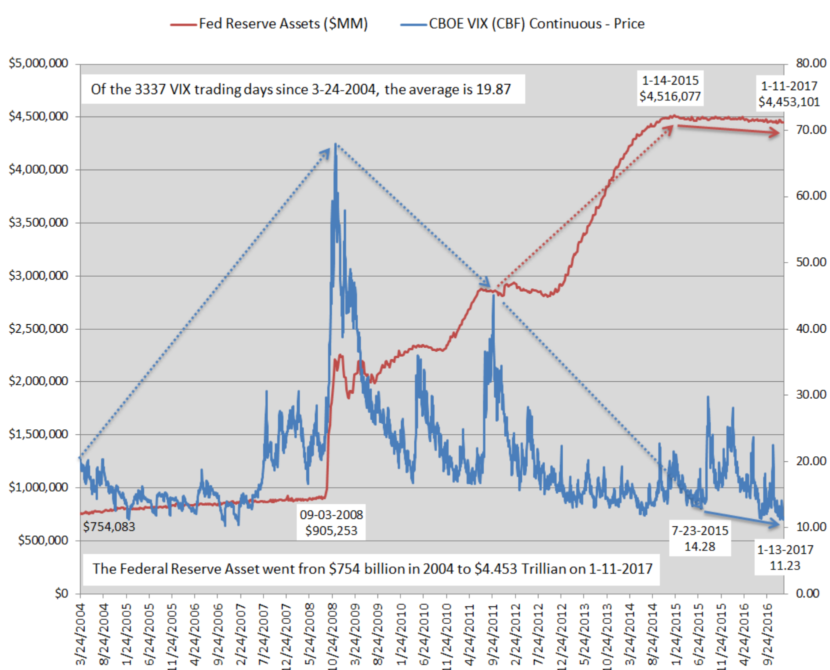
From a January 20, 2016, low of $26.01 per barrel and Brent Crude global delivery price of $54.68 as of January 17, 2017, oil price has certainly recovered, although not at the triple digit level reached in 2008, but this shows a doubling of oil prices in one year. Using the Goldman Sachs Commodity Index (GSCI) as a reference, the index value has increased by 44% since the January 20, 2016, low of 278.04. Although the index is far from the high of 760.33 reached on April 8, 2011, this is still a sign of commodity cost-push inflation price increase.

[4] https://www.newyorkfed.org/microeconomics/sceindex



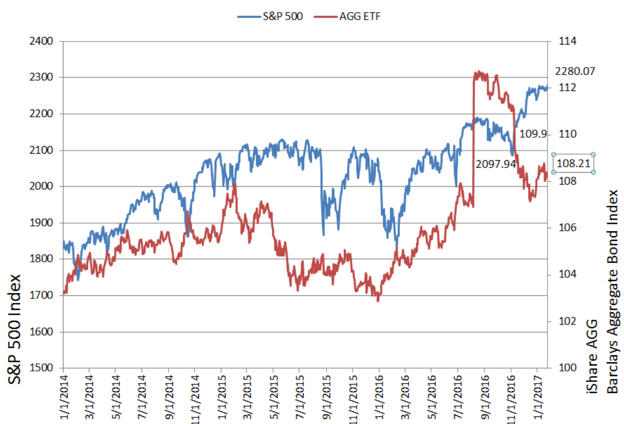
According to the latest CPI and Core CPI reading at 1.7% and 2.1% and PCE and Core PCE at 1.4% and 1.6%, inflation on both core and headline basis have continued to march towards the Federal Reserve 2% inflation floor target. We expect inflation to continue its current trajectory and could surpass the 2% target in the next 12 months depending partially on the FOMC rate decision in 2017 and the scope, scale and timing of fiscal and structural changes under the new administration being realized.

The Financial Markets



Since the end of the Great Depression, the Federal Reserve has employed unconventional monetary policies in an effort to: 1) insert confidence into the banking and financial system 2) serve as the stabilizing force (a financial safety net through QE) to the economy during a period of zero fiscal stimulus, 3) spur investment and borrowing through the use of ZIRP (or even negative real inflation rate), and 4) counter the forces of disinflation and deflation. The record of success is mixed, but there is no debate that the safety net of a bloated Fed balance sheet has added stability (low VIX as an indicator) while financial assets inflated. This is likely to change as the Federal Reserve continues to normalize.

With the end of QE in the fourth quarter 2014 and the first rate increase in December 2015 and a subsequent rate increase in December 2016, bouts of market volatility (VIX) had returned even though the VIX remains relative low. We don't believe this will be sustainable going forward.

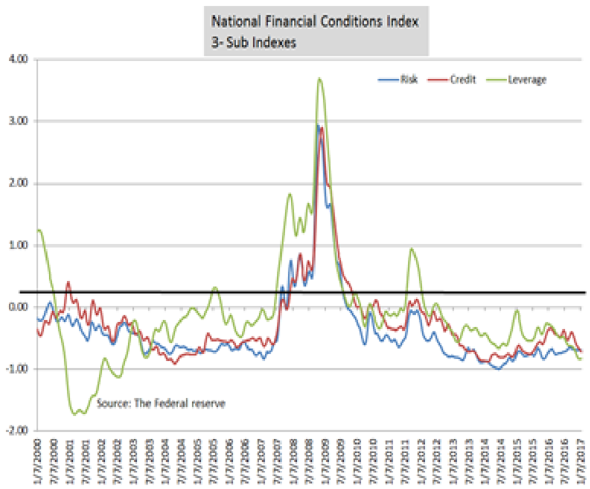


Since the post Brexit low interest rates reached in July last year, interest rates have been normalizing, but a more serious increase in rates (losses in bonds) and melt up in the stock markets came after the Trump victory on November 9th. Since then, the stock market has continued to advance even though fixed income (represented by the AGG) has recovered a bit after a strong selloff.

Benchmark Index, as of 01-24, 2017	Trailing 90-day TR
FIXED INCOME	
BBgBarc Global Aggregate TR USD	-3.91
BBgBarc US Agg Bond TR USD	-2.50
BBgBarc Municipal TR USD	-2.12
BBgBarc US Corporate High Yield TR USD	1.69
BBgBarc US High Yield Loans TR USD	3.30
BBgBarc US Treasury US TIPS TR USD	-1.54
US EQUITIES	
DJ Industrial Average TR USD	9.99
NASDAQ Composite TR USD	5.80
S&P 500 TR USD	6.56
Russell 2000 TR USD	12.05
DEVELOPED MARKET EQUITIES	
MSCI EAFE PR USD	3.13
MSCI EMU PR USD	4.35
MSCI EM Eastern Europe PR USD	12.88
MSCI Japan PR USD	1.83
MSCI United Kingdom GR USD	6.80
MSCI Italy PR USD	10.93
MSCI France PR USD	6.82
MSCI Germany PR USD	8.06
MSCI Spain PR USD	4.55
EMERGING MARKET EQUITIES	
MSCI EM PR USD	-1.06
MSCI Brazil NR USD	0.76
MSCI China PR USD	-3.04
MSCI India PR USD	-4.19
MSCI Russia PR USD	15.22

The table to the left, provided by Morningstar, highlights a number of the benchmark index returns for the trailing 90-days, as of 1-24-2017. This covers the post-election run up of the stock market. Clearly, core (investment grade) fixed income has suffered during a period of rising inflation expectation and the market adjustment to a higher interest environment. There is a definite "risk-on" feel in the developed markets. The emerging markets have been under pressure as a sign of backlash against globalization and trade. The exception is Russia as Donald Trump continues his positive view for Russia's president and a better relationship with Russia. In contrast, Mexico's stock market (not shown here) has suffered a double digit loss as Donald Trump continues his pre-election drive to "build that wall and make Mexico pay for it" and strong-arming automobile manufacturers to retreat from further investments in Mexico. Finally, the threat of renegotiating the terms of NAFTA also places pressure on Mexico's economy.

Although European markets have done well during this period, there is a lot of political uncertainty ahead in 2017 with general elections and the "tapering" by the ECB and the slow unwinding of UK's membership in the European Union. These are known events with uncertain outcomes which have both short and long-term impacts to Europe and the world economy.

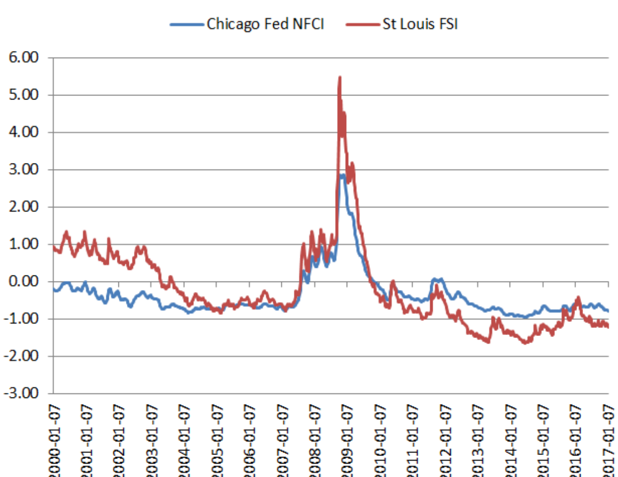


	Current	Previous	1 Month Ago	3 Months Ago	6 Months Ago	12 Months Ago
Index	1/20/2017	1/13/2017	12/23/2016	10/21/2016	7/22/2016	1/22/2016
NFCI	-0.79	-0.79	-0.77	-0.66	-0.66	-0.58

The Federal Reserves created the National Financial Conditions Index (NFCI)[5] to measure the tightness of financial conditions. The average value of the index is zero, and the more positive the value, the higher the financial stress in the system. The NFCI is made up of three subindex components. The risk subindex captures volatility and funding risk in the financial sector; the credit subindex is composed of measures of credit conditions; and the leverage subindex consists of debt and equity measures. Increasing risk, tighter credit conditions and declining leverage are consistent with tightening financial conditions.

	Current	Previous	1 Month Ago	3 Months Ago	6 Months Ago	12 Months Ago
Index	1/20/2017	1/13/2017	12/23/2016	10/21/2016	7/22/2016	1/22/2016
Risk	-0.69	-0.69	-0.69	-0.68	-0.71	-0.69
Credit	-0.72	-0.71	-0.67	-0.47	-0.45	-0.35
Leverage	-0.82	-0.83	-0.84	-0.66	-0.55	-0.29

As of January 27, 2017, all three indexes are negative, meaning that each component is below average value of zero. When compared over the trailing periods, each sub-index has remained the same or at reduced stress levels.



The Chicago National Financial Conditions Index (NFCI) measures risk, liquidity and leverage in money markets and debt and equity markets as well as in the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

The St Louis Financial Stress Index[6] (STFSI) measures the degree of financial stress in the markets and is constructed from 18 weekly data series: seven interest rate series, six yield spreads and five other indicators. Each of these variables captures some aspect of financial stress.

[5] file:///C:/Users/pchao/Downloads/nfci-faqs-pdf.pdf
[6] https://www.stlouisfed.org/news-releases/st-louis-fed-financial-stress-index/stlfsi-key

Accordingly, as the level of financial stress in the economy changes, the data series are likely to move together. Both indexes remain low to historically low.

Monetary Policy

According to the December 2016 meeting minutes[7], the FOMC decided to raise the target range for the federal funds rate at 25bp in light of the economic, employment, and inflation data at the time. This increase was widely anticipated and, as such, was a non-event. The forward guidance language regarding monetary policy remained unchanged from the past – "This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data." Simply stated, the FOMC will remain data dependent and remain focused on inflation now that employement is at or moving towards NAIRU status.

The December meeting also released the FOMC's economic projections, or "dot plot", which summarizes the personal expectation of each voting member on the Committee.

Percent

Variable	Median[1]				
	2016	2017	2018	2019	Longer run
Change in real GDP	1.9	2.1	2.0	1.9	1.8
September projection	1.8	2.0	2.0	1.8	1.8
Unemployment rate	4.7	4.5	4.5	4.5	4.8
September projection	4.8	4.6	4.5	4.6	4.8
PCE inflation	1.5	1.9	2.0	2.0	2.0
September projection	1.3	1.9	2.0	2.0	2.0
Core PCE inflation[4]	1.7	1.8	2.0	2.0	
September projection	1.7	1.8	2.0	2.0	
Memo: Projected appropriate policy path					
Federal funds rate	0.6	1.4	2.1	2.9	3.0
September projection	0.6	1.1	1.9	2.6	2.9

Acording to the projections[8], the U.S. economy remains in the New Normal at a 2.1% real GDP level for 2017 and unemployment is to continue to trend down somewhat to 4.5%. But inflation and core inflation are expected to increase but not reach the 2% annualized rate until 2018. Based on this set of projections, FOMC is expecting the Federal funds rate to be at 1.4%, up 0.3% from its September 2016 projection. This means that the FOMC is expected to raise interest rates 3 times at 25bp each.

FOMC's rate nomalization pace will be influnced by the fiscal and structural policies that can be pushed through the Congress for FY 2017 in October and the various ramifications from Donald Trump's executive orders that may affect global financial conditions.

For Japan, the September 2016 central bank meeting announced a change to its monetary policy. First, it pledged to cap the 10-year government bond at 0%, meaning that the central bank would be a buyer of these 10-year bonds at 0% (i.e. no negative

[7] http://www.chaoco.com/data/images/fomc%20dec%202016%20press%20release%20language%20changes.pdf
[8] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20161214.pdf

nominal rate). The bond buying (i.e. quantitative easing) program shall remain at the rate of ¥80T. This is a part of its yield curve control strategy to keep the short term yield low (currently at -0.1%) and buying fewer long-term bonds to allow the yield curve to steepen. Second, it pledged to continue the open-ended QE bond buying program until inflation "exceeds the price stability target of 2 per cent and stays above the target in a stable manner". This is Japan's version of "whatever it takes" to fight deflation and continue to promote risk taking.

For the European Central Bank (ECB), the December meeting[9] affirmed its current interest rate position without a rate increase and expects the rates to remain low for an extended period of time. (The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.40% respectively.) Further, the ECB announced that it will continue its QE bond buying program at the rate of €80 B through March 2017 and then reduced to €60B per month until the end of 2017; and beyond if necessary. The door remains open if data suggest that a larger or longer program is needed. The QE program extension beginning in April was widely expected but the "tapering" to €60B per month was a surprise even though the ECB confirmed that principal repayments would be reinvested alongside the net purchases to continue to expand its balance sheet.

Regardless of the nuance and granular details as to which part of the yield curve the central banks will buy bonds or the quality and quantity of such purchases, it is clear that Bank of Japan and ECB are continuing their unconventional monetary policies. Both central banks continue to be concerned about deflationary risks and the low aggregate demand and anemic economic growth that have persisted.

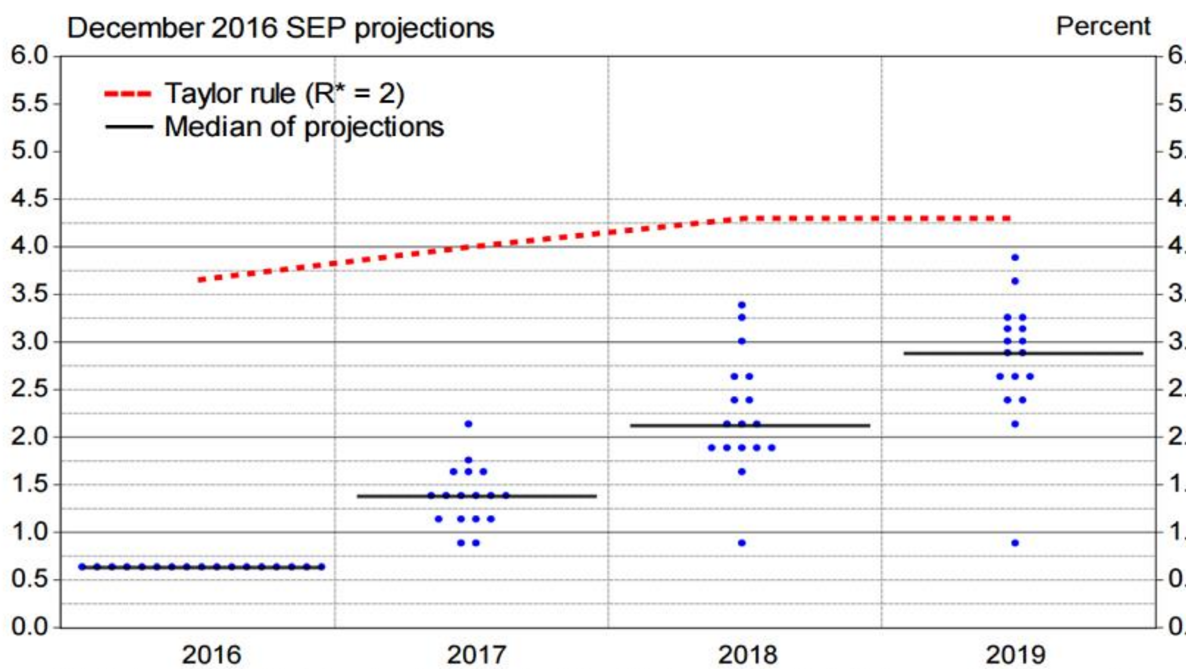
In Chair Yellen's prepared remarks for her 60th annual economic conference[10] at the Federal Reserve Bank of Boston on October 14, 2016, presentation, she stated that "[*i*]*f we assume that hysteresis*[11] *is in fact present to some degree after deep recessions, the natural next question is to ask whether it might be possible to reverse these adverse supply-side effects by temporarily running a 'high-pressure economy,' with robust aggregate demand and a tight labor market. One can certainly identify plausible ways in which this might occur. Increased business sales would almost certainly raise the productive capacity of the economy by encouraging additional capital spending, especially if accompanied by reduced uncertainty about future prospects. In addition, a tight labor market might draw in potential workers who would otherwise sit on the sidelines and encourage job-to-job transitions that could also lead to more-efficient--and, hence, more-productive--job matches. Finally, albeit more speculatively, strong demand could potentially yield significant productivity gains by, among other things, prompting higher levels of research and development spending and increasing the incentives to start new, innovative businesses*."

[9] https://www.ecb.europa.eu/press/pr/date/2016/html/pr161208.en.html
[10] https://www.federalreserve.gov/newsevents/speech/yellen20161014a.htm
[11] "the idea that persistent shortfalls in aggregate demand could adversely affect the supply side of the economy"

Chair Yellen implies that by keeping rates lower for longer to allow the economy to expand faster and greater is a sensible way to reverse the undershooting we have experienced since the Great Recession and set the economy back on course. Since the October suggestion or wanting to temporarily run a "high pressure economy" or hotter economy, Chair Yellen seems to have reversed her position completely.

In Chair Yellen's prepared remarks for her presentation to the Stanford Institute for Economic Policy Research on January 19, 2017, she stated that "*allowing the economy to run markedly and persistently "hot" would be risky and unwise. Waiting too long to remove accommodation could cause inflation expectations to begin ratcheting up, driving actual inflation higher and making it harder to control. The combination of persistently low interest rates and strong labor market conditions could lead to undesirable increases in leverage and other financial imbalances, although such risks would likely take time to emerge. Finally, waiting too long to tighten policy could require the FOMC to eventually raise interest rates rapidly, which could risk disrupting financial markets and pushing the economy into recession. For these reasons, I consider it prudent to adjust the stance of monetary policy gradually over time--a strategy that should improve the prospects that the economy will achieve sustainable growth with the labor market operating at full employment and inflation running at about 2 percent*."

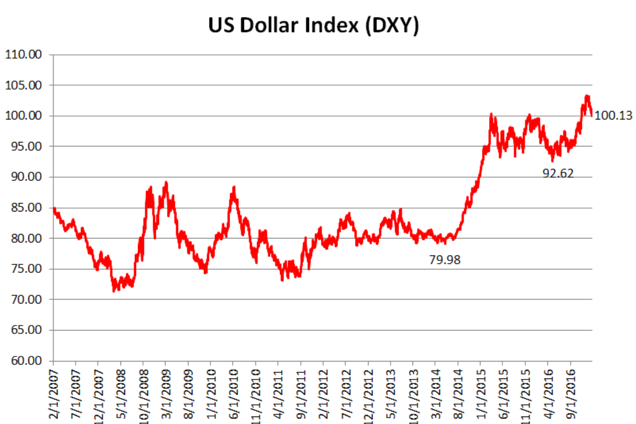
As a part of Chair Yellen's Stanford Institute presentation, she gave some guidance to where the FOMC thinks about the pace of increase to the neutral rate, which is defined as "a level of the federal funds rate that is neither expansionary nor contractionary when the economy is operating near its potential." Figure 5 of Chair Yellen's presentation is a reproduction of the December 2016 released "dot plot".



Note: Each solid circle indicates the value of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate at the end of the specified calendar year.
Source: For the Taylor rule, Federal Reserve Board staff calculations; for the projections (solid circles) and median of projections, Summary of Economic Projections (SEP), December 2016, available at www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

Each dot represents each FOMC participant's assessment of appropriate monetary policy (i.e. Fed Fund's Rate) as compared to the projected neutral rate based on the Taylor Rule[12]. This blue dots clearly show that the FOMC expects the longer-run neutral rate has likely declined below 2 percent, contrary to what is often assumed in implementations of the Taylor rule. The lower rate projection is made in response to accumulating evidence that lower real interest rates are needed permanently to keep the economy operating on a steady state. The black solid lines show the median value of the federal funds rate at the end of each year. Subject to new and developing data, the dots suggest that the median value in 2019 for the neutral rate remains less than 3%. Assuming inflation remains at the projected 2% level, the real neutral rate is just less than 1%. As such, even if the FOMC is reversing its stance on running a high pressure economy for longer, the pace of rate increase is expected to remain slow and steady. But this can all change if the new administration's promised policies are implemented.
Chair Yellen concluded her Stanford presentation by emphasizing the "considerable uncertainty" in projecting the neutral federal fund rate. The productivity growth rate in the U.S. and abroad, the strength of global growth and the size, timing and composition of new fiscal policies are all unknown variables.

The U.S. dollar - Up, Up and Away



Currency is a transmission mechanism which expresses the strength of a country's economy and assets as compared to another country. The DXY is the value of the U.S. dollar relative to a basket of foreign trading partner currencies. Since the April 2016 low, the DXY has jumped. This trend of continuing dollar strength has a financial condition tightening effect and ultimately affects our trade deficits, inflation and interest rates.

As pointed out earlier, the U.S. economy is on solid economic footing and especially when compared to the other developed and certain developing economies. This makes U.S. dollar based assets attractive. Further, the U.S. interest rate, although low, is much higher than many other developed market rates and makes our fixed income more attractive as well. If Trump's growth policies are implemented, that would only make U.S. dollar denominated assets even more appealing. In the long run, dollar strength will put pressure on inflation (imports are cheaper) and economic growth (less market for U.S. goods and services). The other problem is President Trump's narrative

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12 The rule calls for systematic adjustments in the federal funds rate relative to its expected longer-run neutral level in response to movements in inflation and the output gap, defined as the percentage difference between actual output and the economy's productive potential.
The Taylor rule is often implemented by assuming that the real, or inflation adjusted,
value of the longer-run neutral interest rate is equal to 2 percent, roughly the average historical value of the real federal funds rate prior to the financial crisis.

regarding countries that import to us. There will naturally be more trade tensions which could lead to trade wars and currency wars.

Mr. Trump Goes to Washington

The purpose of this section is to offer a frame to understand President Trump. In a highly charged election with a deeply divided electorate, any framing of Trump is taken to the extreme and immediately judged as being supportive or destructive about our President. As investment managers, the clear task is to analyze the new administration and to make informed decisions to adjust portfolio positions to manage downside risks. Comments regarding Trump are not for the purpose to support or disparage him or his policies; rather they are to interpret the new reality as it relates to investing.

After a number of high profile business failures in the 1980s (Trump airline, Trump Taj Mahal, just to name a few), Donald Trump moved from being an owner operator of trophy properties to a promoter of his name globally as a decadence lifestyle brand (Trump vodka, Trump wine, Trump chocolate, Trump Collection for men, Trump Natural Spring Water, Trump Fragrance, Trump Home, Trump Steak in addition to Trump Hotels, Trump Golf Resorts, Trump Wine, just to name a few). Donald Trump has masterfully turned failure into success and created value based on self-promotion. Even though the quality of his licensed products may be debatable, there is little doubt that he has been successful in risking little of his own capital to leverage his name to riches.

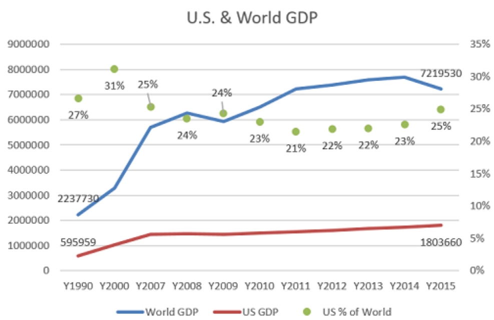
As such, the most important element to his business is him and the reality he creates. He quickly attacks anyone who challenges the reality or edifice of the Trump name or brand. Thus, reality is less important than perception. In 2004, Trump began his first of fourteen seasons as the king judge on the NBC show, "The Apprentice" (subsequently the "Celebrity Apprentice") to further cement his image as the aggressive, self-assured business tycoon where he decides the fate of a single person to gain employment with his organization or to win a pot of money for a charity. This show, in effect, made him the celebrity of all (even though mostly second rate) celebrities. Trump craves respect, approval and being the center of attention. This self-justifying process protects his brand and strengthens his beliefs and commitment to his approach.

Trump's presidential success came as a result of a fortuitous marriage of capturing the anger and frustration of the "average" American voter and his confidence inspiring, let it all hang out, blow up the status quo personage. His firebrand of shock and awe yet simple rhetoric and the unusual connection to his supporters by first debasing them and this country and then insert himself as the sole savior are made for 21st Century television. However, the America greatness he is promising is akin to the 20th century. Trump has masterfully reached backward to capture a period when most of the world was less connected, competition was less intense and the U.S. was more insulated.

Trump believes that it is smart to use "other people's money" (OPM) in doing his deals. He has been very successful in being a serial deal maker and starting a deal and then coming in to close the deal. In his business world, it is about only one thing – to win. When Trump has access to OPM and initiates many deals, he will win even if one deal pans out. Many have wondered if President Trump would be different than Candidate

Trump and others are waiting for the "real" Trump to surface. I suggest what we see is what we get. There is no other Trump than the Trump we have experienced since he declared his candidacy. What has made him successful in his world may or may not be effective when he is now running a country and not a brand, but there should be no surprise that he and his team intend to carry out his campaign promises. In this case, Trump is refreshing that as a politician, he says what he means and he means what he says, or Tweets.

A Word about Trade



According to the World Bank data[13] in 2015 (latest data available), the U.S. GDP at $18 trillion represents 25% of the world GDP of $72.195 trillion. Comparatively, in 1990, $5.95959 trillion U.S. economy, one third the size of our 2015 economy, represented 27% of the $22.3773 trillion world economy which is 31% of the size of today's economy. What we do in this country is material to the rest of the world. As the largest consuming nation, our inward looking policy could invoke trade wars that ultimately harm all parties. As the most powerful country withdraws or brings our alliances into question, it could empower others to be emboldened.

The Three Arrows

In December 2012, Shinzo Abe was elected for the second term as Japan's Prime Minister. He vowed to bring growth back and to stamp out deflation by implementing the three arrows of Abenomics: monetary easing, fiscal spending and structural reform. The principals of Abenomics should not be confined to Japan. In the post GFC world, the three arrows approach is sensible, to a varying degree, for most developed economies. In the U.S., although we have recovered the soonest and we are now on solid footing, the "New Normal" environment of above average labor slack and lower real GDP remain unyielding. What economists believe have been missing or holding this economy back are the two arrows of fiscal and structural reform.

The U.S. economy welcomes the Trump inspired fiscal and structural arrows, and hopefully the fiscal arrow lands on the "right" projects and the structural changes of tax reform do not solely rely on trickledown economics and tax repatriation plan but meaningful tax code overhaul and simplification with tax reduction for the middle and lower income families.

What we see?

The following table offers our firm's forward looking investment view. Our crystal ball is more cloudy than usual as uncertainty is on the rise almost daily. U.S. equities and risk asset prices in general have elevated in anticipation of the arrival of the fiscal and structural arrows referenced above. This means that, due to policy errors or if these lofty expectations (require Congressional approval) do not materialize, the market may

[13] http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?end=2015&start=1960&view=chart

take a serious tumble. In order for the high equity valuation to be sustainable going forward, corporate earnings must be supportive. Even though the real economy remains stable, it is in the New Normal state of below average GDP growth which puts limits on corporate earnings. Much of this fundamental change is predicated on political winds blowing the right way. In the case of fixed income, it is well known that the core fixed income sector is not in a bubble if interest rates remain close to zero.

	Y2017	3 Years
US Equities	neutral	neutral to positive
Developed Market Equities	neutral	neutral to positive
EM Equities	neutral to positive	positive
US Core Fixed Income	negative	neutral to negative
US High Yield Fixed Income	neutral to negative	neutral
TIPS	positive	positive
EM Local Currency Debt	neutral	positive
Commodities	neutral	neutral to positive
US Dollars	positive	neutral to positive
US Inflation	positive	positive
US Interest rates	positive	positive

However, the FOMC is broadcasting its path to normalization (3 expected rate increases this year), and with the recognition of reflation in the economy, interest rates could rise at even a faster pace than the market expects. This would cause havoc in the fixed income space as well. Then there is the perpetual excitement about emerging markets where the demographics are right and they are the growth engines of the world. In the long run, these fundamental factors may prove profitable, but in the short term, U.S. trade policies, dollar strength, de-globalization, geo-political tensions, and nationalism trends are not favorable to emerging markets. Our concern is that historical correlation among asset classes (i.e. how each investment moves in concert or independent from each other) may breakdown and the ability to diversify portfolio risk is ever more challenged.

Let's hope that the year of the Cocky Rooster will bring us unyielding pride and prosperity!

Sincerely,
CHAO & COMPANY, LTD.
Philip Chao
Principal & CIO