Highlights

- We are raising our cash allocation from 10% to 15%
- Recession risk and bear market risk are low
- A 10% correction would be good for the market

Geopolitical Landscape

World leaders and policy makers are bracing for the unknown effects of Brexit and Trump. The 2017 geopolitical landscape is changing rapidly, and nobody knows how things will shake out. There will be winners and losers, so everyone is scrambling to get on the right side of what's coming.

Geopolitical risks are unusually high, due mostly but not entirely to what's going on in Europe (implementing Brexit), and what's going on in the U.S.A. (the unpredictability of a president who is learning on the job.) But in spite of this heightened state of unease, we are still optimistic that the global economy will continue to improve, and corporate earnings will continue to grow. There will undoubtably be shocks to the system, and some dislocations in the balance of trade and commerce, but we don't expect policy mistakes that are so serious that they will knock the economy off its track.

Our expectation is that these shocks to the system will not be fatal to the global economy, but they could certainly cause sharp reactions in the capital markets. Our strategy is to raise a little cash, reduce our equity risk exposure slightly, and wait for opportunities to capitalize on spikes in volatility.

Details

The Economy

On the whole, recent economic data has been stronger than at any point since the recovery started in 2009. The labor market continues to create jobs at a healthy pace. Both consumer and business sentiment indicators have improved since the election. And stock markets have rallied, which is usually a good sign for economic activity down the road, especially for business investment. In fact, the economic data and financial market conditions have been so strong that the Fed decided to hike rates on March 15th, sooner than the market had been expecting at the beginning of the year.

Equities

We are raising our cash allocation from 10% to 15%. This is a tactical move, not an indication of a change in our long term outlook for stocks. We just want to do a little de-risking and have a little more buying power available for pullbacks.

Profit growth should remain healthy for the rest of the year as the headwinds from the commodity downdraft continue to fade. Consumer spending remains well-supported by job gains, management teams are sounding a more optimistic tone, and bank lending standards are signaling an improving trend.

Even if there is some delay to the Trump administration's corporate tax reform proposals, the profit improvement remains on solid footing and an assist from Washington would merely be icing on the cake. Sustained economic growth and the improving outlook for corporate profits are key drivers behind our overweight stance on US and global equities. We continue to favor U.S. equities, but our return projections are coming down. We expect 0-5% nominal returns this year, and not much more than that if we look out further into the future.

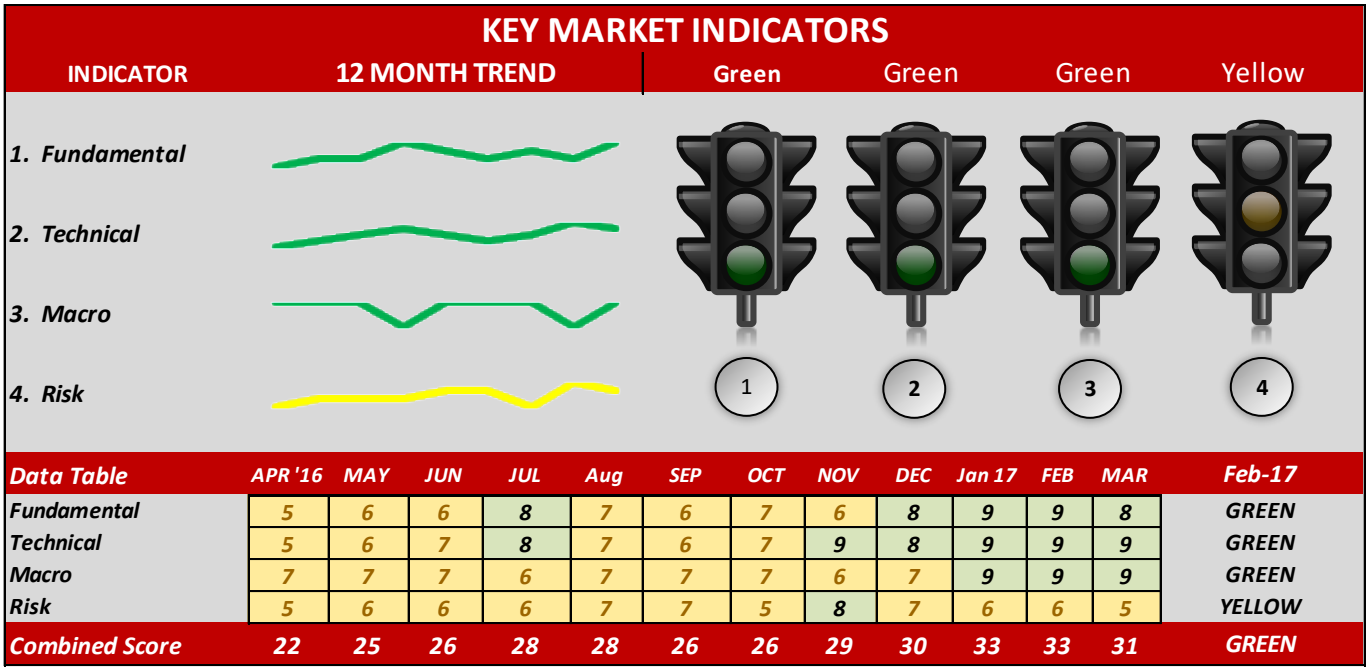
For non-U.S. developed market equities, we have a more positive outlook. Valuations compare favorably to those in the U.S., so we have a return estimate of 7-10% for this asset class.

Fixed income

We hold overweight positions in US Treasury Inflation Protected Securities (TIPS) and US High Yield. While inflation expectations have caught up to the reality of rising prices, limiting prospects for near-term outperformance of the position, TIPS continue to offer portfolio protection against an overshooting of inflation rates.

We also expect long-term USD yields to move sideways and the yield curve to flatten as the US economy grows and the Fed gradually raises the policy rate.

The Overall Health of the Market



Data Table	APR '16	MAY	JUN	JUL	Aug	SEP	OCT	NOV	DEC	Jan 17	FEB	MAR	Feb-17
Fundamental	5	6	6	8	7	6	7	6	8	9	9	8	GREEN
Technical	5	6	7	8	7	6	7	9	8	9	9	9	GREEN
Macro	7	7	7	6	7	7	7	6	7	9	9	9	GREEN
Risk	5	6	6	6	7	7	5	8	7	6	6	5	YELLOW
Combined Score	22	25	26	28	28	26	26	29	30	33	33	31	GREEN

Our key indicators of the overall health of the market remain in a bullish state. As long as the Macro and Technical components remain green, corrections are likely to be short and shallow. The sole yellow flag is Risk. Our view is that the risk of mistakes on the part of policy makers in Britain and the U.S. are high enough to warrant extra caution. Elevated valuations means that there will be considerable downside risk once the Macro picture starts to degrade. But until that happens, stay invested.

Stock market outlook

Chart 1. S&P 500 with Zone of Death Parameters

Chart 1 shows the track of the year-over-year percent change in the S&P for the last 12 months. The green line represents the price level that is 10% above where the market was trading one year ago. The red line represents a 10% decline from year-ago prices. The **Zone of Death** is the area between these two lines.

The current reading is a healthy 15.1% gain over the last 12 months. We watch this line for early clues about deteriorating market momentum.

Chart 2. Market Momentum

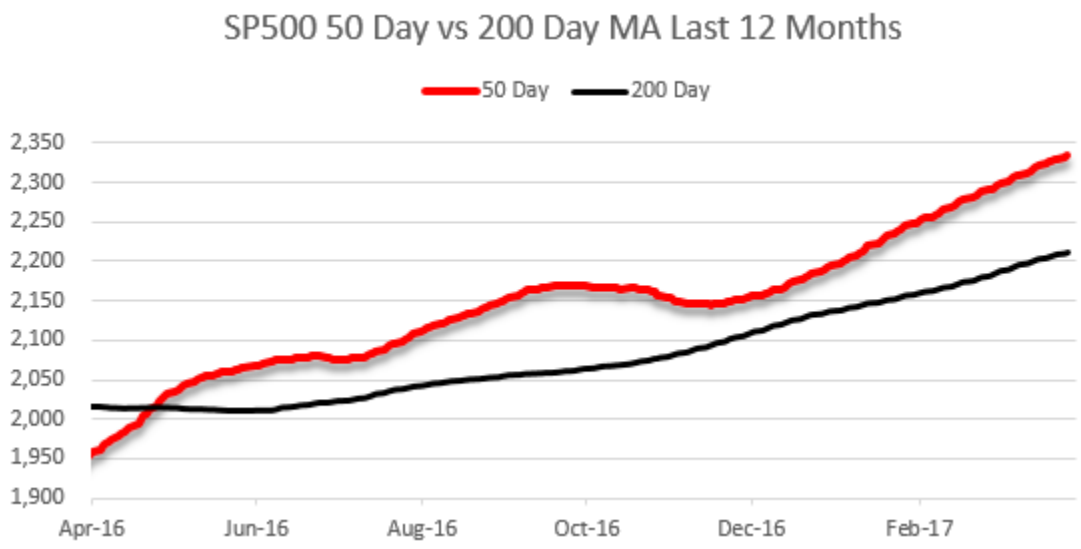


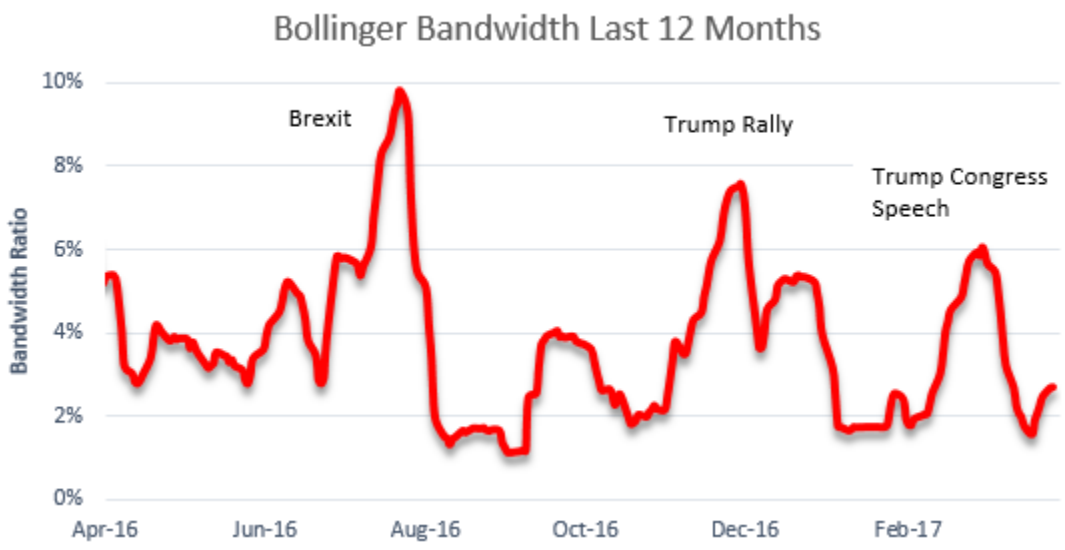
Chart 2 shows market momentum as represented by the relationship between the short term (red line) and long term (black line) moving averages. The black line is the 200 day moving average. The red line is the 50 day moving average. The current state of this indicator is very healthy, which further supports our case that the bull market is still in place.

An old adage among equity traders is "don't fight the tape." Looking at this chart is a good way to visualize the tape, and it's clear that the bulls are still in charge.

The next two charts show how calm the market has been over the past year. The Bollinger Bands represent the magnitude of daily price swings in the market, averaged over the last 20 days. It has been trending lower all year. This means that the tug-of-war between buyers and sellers has reached a near stalemate.

The Treasury-Junk Bond spread represents the strength of resolve among risky bond buyers, which implies that they're optimistic about the near-term economic future. As this number trends lower, bond buyers and other yield-seekers are becoming increasingly bold.

Chart 3. Volatility



Bollinger bandwidth is a measure of the daily variability of prices. Over the long term, the bandwidth is about 5%. Today it's half that, which indicates a calm and confident market. But notice the uptick over the last few days. It could mean nothing but noise, but it's worth keeping an eye on.

The last three spikes in volatility are shown on the chart above. Brexit, the start of the Trump rally, and Trump's address to Congress all triggered mini-spikes in market volatility. Keep in mind that the Bollinger reading doesn't discriminate between up or down moves in the market. It just indicates that there's a disturbance in the force that merits further investigation.

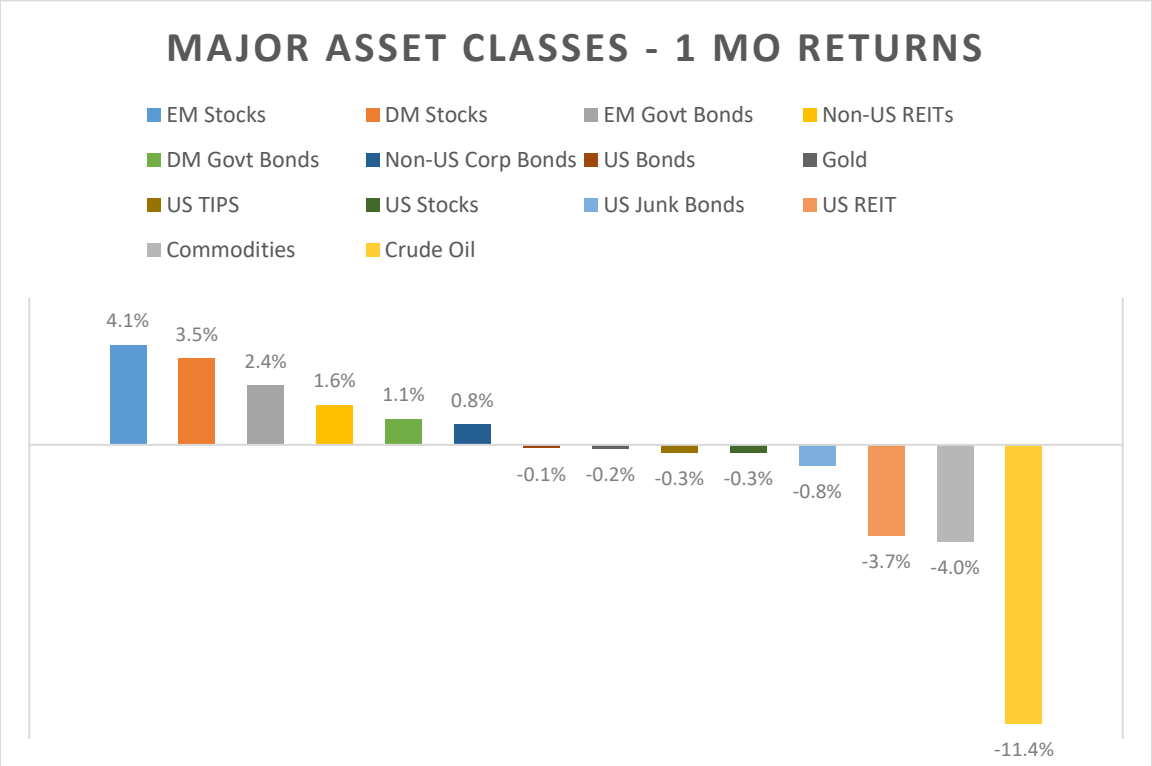
Chart 4. Interest rate spread between Junk and Treasury Bonds

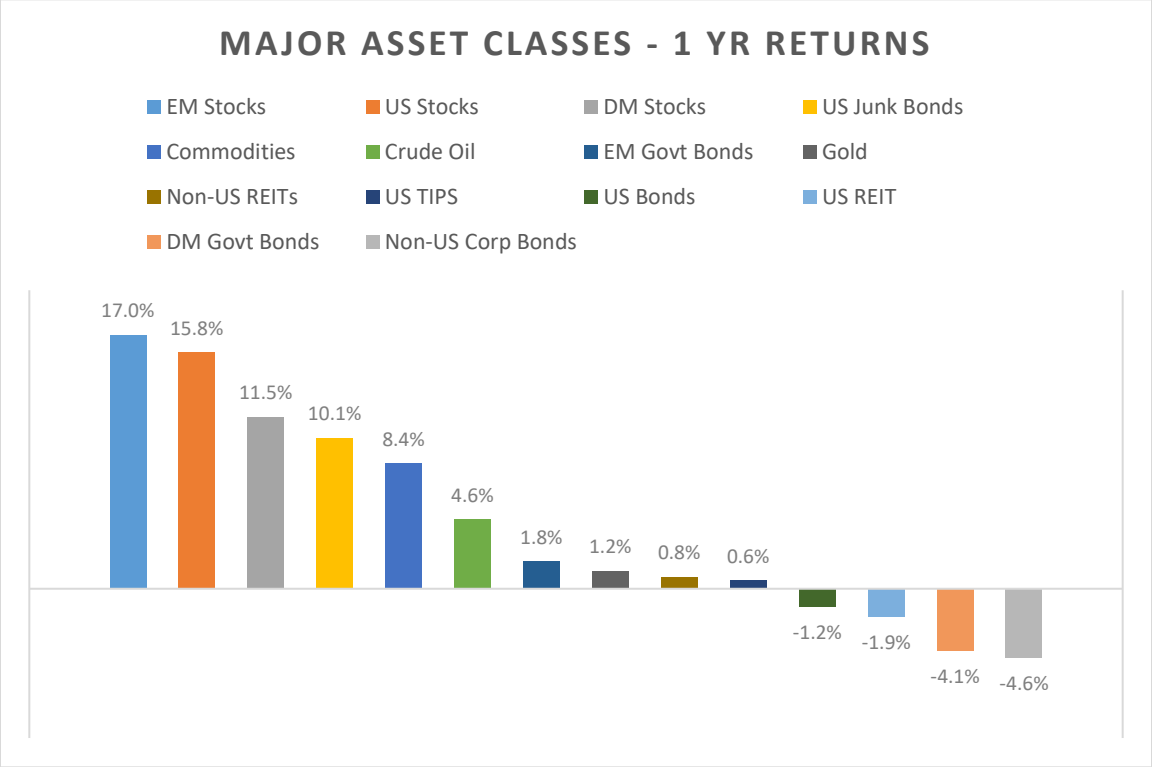
After a full year of narrowing, the Junk-Treasury spread is starting to widen a bit. This may just be a blip, but it could also be a sign of bond investor worry. There are two ways to make this line go up. If bond buyers are selling junk, this line goes up. It indicates rising concern in the bond market. If Treasury buyers are buying aggressively, the line also goes up. Either way, a rising spread represents an uptick in concern among bond buyers.

Asset Class Leaders & Laggards

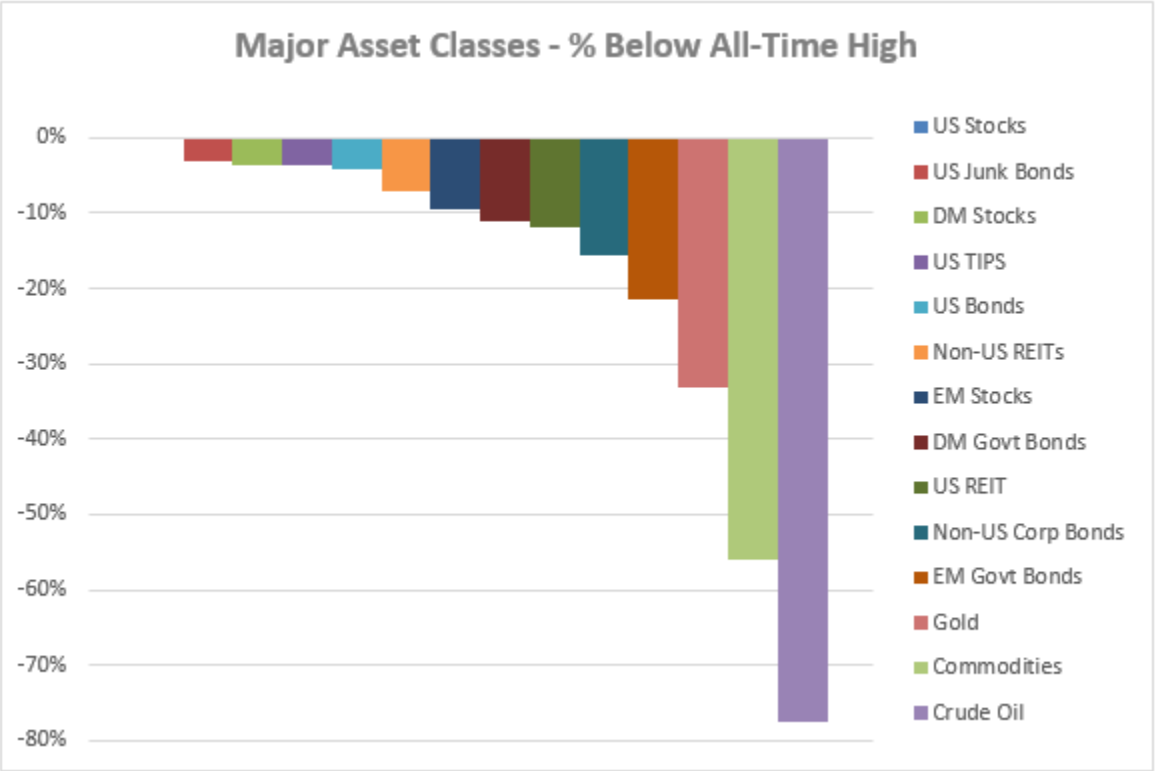
For the last couple of years, U.S. stocks have been leading the global equity markets higher. But when we look at just the last 12 months, Emerging Market stocks have come on strong and are now leading the pack.

On a one-month basis, this pattern is repeated, as U.S. stocks have gone nowhere while non-U.S. stocks and bonds are on a hot streak.





Another way to compare asset classes is to look at how far each one is trading, relative to its all-time high. U.S. stocks are very close to their highs, while crude oil is 77% below its high water mark.



Picks & Pans

ZI 10 Best ETFs: The 10 most undervalued asset class ETFs

Symbol	Name	1 Year
NGE	Global X MSCI Nigeria ETF	-36.05%
EGPT	VanEck Vectors Egypt Index ETF	-25.28%
KWT	VanEck Vectors Solar Energy ETF	-22.96%
TAN	Guggenheim Solar ETF	-18.58%
TUR	iShares MSCI Turkey ETF	-15.40%
MOM	US Market Neutral Momentum Fund	-13.76%
EDV	Vanguard Extended Duration Treasury ETF	-9.25%
ZROZ	PIMCO 25 Yr Zero Cpn Treasury ETF	-8.38%
XRT	SPDR S&P Retail ETF	-6.62%
EWM	iShares MSCI Malaysia ETF	-6.52%

ZI 10 Worst ETFs: The 10 most overvalued asset class ETFs

Symbol	Name	1 Year
RSXJ	VanEck Vectors Russia Small-Cap ETF	93.04%
KOL	VanEck Vectors Coal ETF	88.80%
EWZS	iShares MSCI Brazil Small Cap ETF	65.75%
SLX	VanEck Vectors Steel ETF	65.66%
PSI	Powershares Dynamic Semiconductor ETF	62.62%
COPX	Global X Copper Miners ETF	62.34%
BBP	BioShares Biotech Products Fund	60.40%
AMZA	InfraCap MLP ETF	56.15%
SILJ	PureFunds ISE Junior Silver ETF	48.55%
PSCM	PowerShares S&P Sm Cap Materials ETF	48.30%
XME	SPDR S&P Metals & Mining ETF	47.47%

ZI 10 Best Performing Industries

Industry Group	3 Month Change	1 Year Change
Banks	-2.1%	38.4%
Basic Resources	-4.7%	27.1%
Media	6.2%	20.0%
Chemicals	5.9%	19.6%
Industrial Goods	2.0%	17.6%
Travel & Leisure	4.1%	12.5%
Autos & Parts	2.8%	9.2%
Household Goods	10.0%	8.8%
Food & Beverage	2.7%	5.9%
Real Estate	1.8%	3.0%

Banks and Basic Resources have corrected some of the excess valuation they built up since the election. But they are still the top two industries on the list for the full year.

ZI 10 Worst Performing Industries

Industry Group	3 Month Change	1 Year Change
Alternative Energy	-17.0%	-48.8%
Electronic Office Equipment	-19.8%	-40.1%
Clothing & Accessories	-2.4%	-19.8%
Retail REITs	-6.0%	-14.4%
Drug Retailers	0.1%	-10.9%
Footwear	9.4%	-7.6%
Apparel Retailers	-5.0%	-7.4%
Media Agencies	-2.3%	-3.3%
Fixed Line Telecommunications	-5.5%	-1.9%
Food Retailers & Wholesalers	-5.1%	-1.6%

Alternative Energy is the biggest loser in the new era of the return of big oil, fracking, pipelines and coal. Electronic Office Equipment is the second worst. These two industries may be good candidates for a mean-reversion contrarian long bet.

ZI 10 Best Stocks: The 10 most undervalued stocks

Company	Ticker	Current Price	Avg Daily $Volume	P/E using 12 mo Est	Price/ Sales	Price/ Book	Earnings Est Revisions	Debt/ Equity	Technical Grade	Funda-mental Grade
Century Alum Co	CENX	$12.40	30,154,270	17.22	0.82	1.43	146.15	0.33	A	B
Health Ins Inn	HIIQ	$15.05	7,654,144	10.24	1.29	2.80	33.64	0.00	B	A
Lennar Corp -A	LEN	$51.50	159,266,768	12.15	1.07	1.67	2.39	0.63	B	B
Meredith Corp	MDP	$63.90	40,416,924	16.51	1.67	2.97	3.29	0.64	A	B
Nippon Tele-Adr	NTT	$44.11	16,461,100	12.86	0.88	0.89	2.39	0.29	A	A
Nucor Corp	NUE	$59.77	169,721,056	14.14	1.18	2.31	11.87	0.45	B	A
Panasonic Corp	PCRFY	$11.40	1,480,969	14.61	0.39	1.45	3.31	0.56	A	B
Tech Data Corp	TECD	$90.96	32,236,852	9.81	0.13	1.48	47.28	0.46	B	A
Wabash National	WNC	$20.37	19,501,360	13.69	0.66	2.68	1.88	0.50	A	A
Zagg Inc	ZAGG	$7.00	2,515,850	8.25	0.49	1.68	60.00	0.08	A	A

The stocks in the table above have two things going for them. They are all undervalued (cheap), and they get high marks for both fundamental and technical strength. Don't rush out and buy them based on this list alone. Consider this a watch list that bears further study.

ZI 10 Best Shorts: The 10 most overvalued stocks

Company	Ticker	Current Price	Avg Daily Volume	Debt/ Equity	P/E using 12 mo Est	% Chg Earnings Est This Year	% Chg Earnings Est Next Year	Technical Grade	Funda-mental Grade
Agnico Eagle	AEM	$43.16	1,872,281	0.24	88.6	-64.39	-47.75	C	F
Amag Pharma Inc	AMAG	$22.85	1,053,455	1.03	225.49	-81.21	-178.06	C	C
Anadarko Petrol	APC	$62.45	4,449,369	0.99	414.07	-91.04	-34.42	D	C
Athenahealth In	ATHN	$111.27	369,288	0.43	87.13	-1.59	-2.37	D	C
Echostar Corp	SATS	$55.09	242,534	0.90	65.25	-35.17	-39.44	D	F
Keyw Holding Cp	KEYW	$9.52	536,057	0.57	59.87	-42.86	-9.68	F	D
Martin Midstrm	MMLP	$19.35	281,474	2.59	62.97	-61.86	-59.76	D	D
Monotype Imagng	TYPE	$19.50	192,909	0.33	56.01	-39.56	-15.44	F	D
Neogenomics Inc	NEO	$7.72	295,191	0.60	52.91	-20.44	-18.52	F	D
Shutterfly Inc	SFLY	$47.62	457,997	0.50	62.85	-54.94	-28.03	C	D

The stocks in the above table are the bottom of the barrel, in terms of high valuations, and low marks for fundamental and technical soundness. Consider them as short candidates, but do your own due diligence before acting on them. Some of them are hard to borrow, so you wouldn't be able to short them at all.

Our Forecast for the U.S. Economy

Moderate expansion - Probability: 70%
Corporate earnings are on the rise. This improving trend should continue with S&P 500 earnings growth turning even more positive in the 1st quarter. The big drag on profits from the strong US dollar and poor energy sector results have largely run their course.

Strong expansion - Probability: 10%
Higher interest rates and rising commodity prices, driven by improving global growth prospects, could produce stronger-than-anticipated S&P 500 EPS growth as energy and financials – roughly 25% of S&P 500 profits – could see a meaningful profit improvement.

Growth recession - Probability: 10%
A downturn in US and global growth could lead to weaker-than-projected revenues for S&P 500 companies. Wage pressures, unaccompanied by improving consumer and business demand, could pressure profit margins and earnings growth rates.

Outright recession - Probability: 10%
Our indicators, both leading and coincident, point to continued growth in the U.S. We view the election of Donald Trump as a source of uncertainty for the global economy and markets. Other risks would be a major terrorist attack, a policy mistake by the Fed, or the onset of a trade war between the U.S. and China or Mexico.

Key Recession Indicators

The risk of the US economy sliding into recession in the next 6 months is very low - just 10% as of the end of February. We base this estimate on a combination of factors (see the table below) that have proven accurate in calling turns in the business cycle. Our model is not perfect, but it will tell us when the conditions are in place for a turn in the cycle.

The latest readings (for February 2017) show a slight improvement over last month's numbers. The two leading indicators, Market Stress and Market Trend, are forecasting continued economic growth and positive market momentum for the next 3 to 6 months. The coincident indicators are confirming this outlook.

The takeaway from all of this is that the economy is strong enough to support the stock market. In the absence of a recession, corrections in the stock market are limited. It's not unusual to see a 10% to 15% decline in the market without a recession taking place. We think the probability of a correction of this magnitude is about 40%. That's high enough for us to raise a little cash, so that we will be in a better position to buy stocks at cheaper prices over the next few months.

Recession Watch

Indicator	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
R-Score	423	404	384	376	371	366	343	336	353	355	278	256
Employment	2.2	2.1	1.9	1.9	2.0	2.0	1.9	1.8	1.9	108.0	1.8	1.8
Ind Production	-2.0	-1.4	-1.2	-0.6	-0.6	-1.1	-1.1	-0.7	-0.3	0.7	0.2	0.3
Market Trend	-0.4	-1.0	-0.7	1.0	3.1	9.6	12.7	2.3	4.6	9.5	17.5	19.1
Market Stress	8.7	6.4	14.1	9.3	10.9	14.0	14.9	4.3	13.7	15.5	19.5	26.4
Junk Spread	7.0	6.6	6.1	6.2	5.7	5.1	5.0	4.9	4.7	4.2	4.0	4.1

Red numbers indicate warning, based on these parameters:

R-Score	< 200	This indicator combines the treasury yield curve, inflation, and unemployment.
Employment	< 1%	Year-on-year changes in private non-farm employment.
Ind Production	< 1%	Year-on-year changes in industrial production.
Market Trend	< -5%	Year-on-year changes in the S&P 500 index.
Market Stress	< 0	△△Combination of stock market price change and the unemployment rate change.
Junk Spread	> 7.5%	Difference between Junk bond yield and Treasury bond yield

Our Forecast of Asset Prices

12 Month Forecast of Asset Prices

Asset Class	Benchmark	Current Value	12 Month Forecast
Stocks			
U.S.	S&P 500	2361	2250
Non-U.S. Developed	VEA	39.36	40.00
Emerging Markets	EEM	39.67	40.00
Bonds			
U.S. Govt	10yr T-Bond	2.4%	2.9%
U.S. Corporate	Current Yield	3.3%	4.2%
U.S. High Yield	Current Yield	5.5%	6.8%
Munis	Current Yield	2.1%	2.5%
Other			
Gold	Spot	1256	1300
Oil	WTI	49.66	53

As of 3/29/17 *Source: Bloomberg; Atlanta Fed; UBS*

We expect a small loss between now and the end of 2017. You may be wondering how I can be forecasting a flat market while at the same time urging readers to stay fully invested. Isn't this a contradiction? No, but it does reflect an internal conflict between bullishness based on my model, and cautiousness based on my concerns about valuation and geopolitical uncertainty.

For now, we expect a continuation of the rally that could take the S&P 500 to 2500, or maybe even a little higher. But at some point, the effect of gravity (valuations) and rising rates will start to weigh on the stock market. Valuations are stretched, and the market can't sustain itself without a sizeable boost in corporate earnings. The 8% increase that analysts are predicting will only bring valuations closer to long term averages.

In addition, the risks of a serious policy mistake by the new administration will probably cause a spike in volatility at some point. The question then becomes, how resilient will the economy be to these events? That's why I'm calling for a flat year. And it would not surprise me to see an intra-year drawdown on the order of 15% or so, before recovering to end the year flat.

As long as the internal indicators of market health and economic expansion remain positive, I will continue to advocate a fully invested asset allocation. As I said earlier, raising a little extra cash would be fine, but take it slow.

Subscribers to this letter will get advanced warning from me before I go public with a major change to a defensive posture.

Asset allocation

Improving global growth, rising earnings, and stock price momentum justify a moderately risk-on stance for now. But we also want to try and limit the downside in the event of increased volatility or negative economic surprises over the next 6 to 12 months.

Accordingly, we are reducing our risk exposure by taking 5% out of equities and adding it to our cash reserve. We think the market will present us with an opportunity to return to a full equity allocation sometime later this year.

The uptick in global economic data has been broad-based across developed and emerging markets alike. The Citi Economic Surprise Index for major economies is near a six-year high, and purchasing managers' indexes point to expansion in most major economies. Over 70% of the developed markets that CIO covers exhibit stronger earnings-per-share momentum than six months ago. And while equity valuations are no longer cheap, the MSCI All Country World Index is trading close to its 20-year average, a level that hasn't historically prevented further appreciation.

We are overweight US high yield credit. US high yield offers an attractive yield to maturity of 6.4%, and credit quality is being boosted by accelerating economic growth. The asset class has struggled in the face of a weaker oil price (energy firms are almost 15% of the market) and heavy new issuance. But we expect the oil rally to resume as production cuts from OPEC start to reduce the global oversupply.

We are underweight government bonds overall, as low yields suggest that income and capital gains for developed market government debt are limited.

Our Current Asset Allocation

Asset allocation: taxable

Investor Risk Profile ----->	Conservative	Moderate	Aggressive
Summary			
Stocks	**29.5**	**38.0**	**53.0**
Bonds	**36.5**	**35.0**	**25.0**
Commodities	**4.0**	**5.0**	**5.0**
Cash	**15.0**	**13.0**	**10.0**
Non-traditional assets	**15.0**	**9.0**	**7.0**
	100.0	**100.0**	**100.0**
Details			
US Large Cap Stocks	9.0	12.0	17.0
US Mid Cap Stocks	4.0	7.0	8.0
US Small Cap Stocks	2.0	3.0	4.0
US Stocks Total	**15.0**	**22.0**	**29.0**
Intl Developed Mkt Stocks	8.5	9.0	14.0
Intl Emerging Mkt Stocks	6.0	7.0	10.0
Non-US Stocks Total	**14.5**	**16.0**	**24.0**
US Treasury Bonds	4.0	3.0	2.0
US Muni Bonds	20.0	17.0	9.0
US Corporate Bonds	3.0	4.0	2.0
US High Yield Bonds	3.5	4.0	5.0
US Bonds Total	**30.5**	**28.0**	**18.0**
Intl Developed Mkt Bonds	3.0	3.0	2.0
Intl Emerging Mkt Bonds	3.0	4.0	5.0
Non-US Bonds Total	**6.0**	**7.0**	**7.0**
Cash Total	**15.0**	**13.0**	**10.0**
Energy	1.0	1.0	1.0
Precious Metals	1.0	1.0	1.0
Crops & Livestock	2.0	3.0	3.0
Commodities Total	**4.0**	**5.0**	**5.0**
Hedge Funds	10.0	3.0	2.0
Managed Futures	5.0	6.0	5.0
Non-traditional assets Total	15.0	9.0	7.0
	100.0	100.0	100.0

As of 3/29/17

(The above allocation is for taxable accounts with an investment horizon of 20 or more years.)

Asset allocation: tax-deferred

Investor Risk Profile ----->	Conservative	Moderate	Aggressive
Summary			
Stocks	**23.0**	**37.0**	**48.0**
Bonds	**48.0**	**36.0**	**30.0**
Commodities	**6.0**	**5.0**	**5.0**
Cash	**15.0**	**12.0**	**11.0**
Non-traditional assets	**8.0**	**10.0**	**6.0**
	100.0	**100.0**	**100.0**
Details			
US Large Cap Stocks	9.0	12.0	17.0
US Mid Cap Stocks	3.0	6.0	7.0
US Small Cap Stocks	2.0	3.0	6.0
US Stocks Total	**14.0**	**21.0**	**30.0**
Intl Developed Mkt Stocks	5.0	8.0	9.0
Intl Emerging Mkt Stocks	4.0	8.0	9.0
Non-US Stocks Total	**9.0**	**16.0**	**18.0**
US Treasury Bonds	25.0	19.5	13.0
US Muni Bonds	3.0	0.0	0.0
US Corporate Bonds	7.0	4.0	2.0
US High Yield Bonds	6.0	6.0	8.0
US Bonds Total	**41.0**	**29.5**	**23.0**
Intl Developed Mkt Bonds	4.0	2.5	2.0
Intl Emerging Mkt Bonds	3.0	4.0	5.0
Non-US Bonds Total	**7.0**	**6.5**	**7.0**
Cash Total	**15.0**	**12.0**	**11.0**
Energy	2.0	2.0	2.0
Precious Metals	2.0	1.0	1.0
Crops & Livestock	2.0	2.0	2.0
Commodities Total	**6.0**	**5.0**	**5.0**
Hedge Funds	6.0	6.0	3.0
Managed Futures	2.0	4.0	3.0
Non-traditional assets Total	8.0	10.0	6.0
	100.0	100.0	100.0

As of 3/29/17

(The above allocation is for tax-deferred accounts with an investment horizon of 20 or more years.)