May 19, 2017

Centre Funds Insight – Spring/Summer 2017 Market Review & Outlook – U.S. Equities

It's tough for us to remember a period of time other than the election of Ronald Reagan in 1980 when a change in the U.S. presidency ushered in such a change in hope, at least in terms of expression by financial markets. Perhaps it is due to the shift in near-consensus thinking that Hillary Clinton, as the candidate of the "establishment" and representing continuity with President Obama rightly or wrongly, would win and that the general prevailing environment characterized by low growth, low interest rates, and company earnings driven almost solely from either innovation, cost-cutting or, more ominously, financial engineering, would continue indefinitely. Thus, leaving those geared toward an improving economy languishing with near nil top-line growth and deteriorating profit margin outlooks due to the lack of operating leverage.

With low interest rates leaving little alternative for investors, the flow into equities, particularly from early 2015, narrowed towards those companies that genuinely could distinguish themselves with innovative growth or stable earnings and, hence, were afforded valuation multiples only seen at other prior market cycle peaks and reminiscent of the original Nifty-Fifty era. This all seemed to change the day after the election. Namely, the narrative for owning stocks shifted from the "stick" of low interest rates to the "carrot" of better economic growth, with the hope that this would lead to an acceleration of profits after a more than two year period of broad based profits and margin decline. Although profits did begin to turn up in the summer of 2016 due to stability of commodity prices mainly, forward looking and long term expectations across all sectors took on an incredibly robust tone afterwards. The important point to make in all this is that the election of Donald Trump is potentially a move away from the status quo. His expressed policy changes, if effected, would likely move us to a market environment that is much different from the one that we have been in since 2014, which is reflected in the stock market's performance since the election. Thus far however, it seems that Trump is being consumed by the Washington "swamp" rather than enforcing his stated populist goal to drain it so investors find themselves facing greater uncertainty which should by itself increase risk premiums and lower valuation multiples across all financial assets.

It cannot be stressed enough that support for Trump in the recent U.S. Presidential election came in strong force from the U.S. industrial and agricultural heartlands. The blue-collar workers in these States such as Pennsylvania, Michigan, and Ohio have had to contend with the loss of higher-paying manufacturing jobs and increased benefit and retirement uncertainty. The steady offshoring of American manufacturing jobs to lower cost countries, most notably Mexico and China, has come about through the implementation of the North American Free Trade Agreement ("NAFTA") and China's entry into the World Trade Organization ("WTO") under favorable currency conditions that has since tremendously benefitted China in its mercantilist trade. In the meantime, U.S. corporations have benefited from much lower input costs without having to face any costs on importation of their products as well as being able to subordinate their traditional pension obligations to the government or domestic workforce. Candidate Trump effectively blamed the political class and promised to introduce measures to "make America great again". Furthermore, his celebrity and showmanship allowed him to be perceived as the only person who could take decisive action, even though his policies for doing so were, to many, somewhat incoherent and many voters relied on the hope that he actually believed in what he espoused on the campaign trail as opposed to being some dilettante.

From an economic perspective, Trump has advocated tax and trade measures that will address the problems created by free trade or what he calls, "bad trade deals". Trump also expressed an "America-first" policy, which could result in a retreat from America's role as a global policeman that's been in place since the 1950's and a re-focus of the White House's energy on domestic problems, particularly America's ageing infrastructure. In sum, Trump has expressed the need to prioritize creating economic growth that will actually benefit his core constituencies in industrial America. Extending the impact of his pro-growth priorities makes a strong case for better domestic economic growth but it also may create an environment of higher inflation and interest rates as well as higher compensation and input costs, which historically have been bad for the stock market. In essence, President Trump is in a quandary, implement measures that satisfy his voter base and increase economic growth but, at the same time, contribute to what may be a very poor stock market as profit margins and valuations compress. We don't see how he can accomplish both, particularly since broad market valuation measures that we deem important indicate that U.S. stocks, on a median basis, are the most expensively valued ever, even more so than in 2000 or in 2008 prior to the start of severe market declines. Furthermore, the degree of financial engineering – stock buybacks financed with debt, etc. – is highly dependent on an environment of low interest rates and vulnerable to increases in inflation and debt risk premiums.

Unfortunately, the Reaganesque hope parallel that surrounds financial markets today has several potential problems, and the challenges that Trump faces are relatively daunting, maybe because of very unequal starting points between 1980 and today. Firstly, on a macro basis the U.S. has a debt to GDP ratio of over 100% and U.S. corporations have exceptionally high debt to assets ratios, both of which are only serviceable due to extraordinary low interest rates. This leaves little room to undertake the massive capital investment and infrastructure plans, public and private, without jeopardizing the existing serviceability of debt as interest rates would be expected to rise, perhaps significantly. Rates are already too low and are rising, suggesting an economic headwind rather than support. Secondly, the growth of developing countries as manufacturing destinations as a lower-cost alternative is somewhat entrenched due to the incredible transfer of knowledge and intellectual property overseas and the fact that significant wage differentials still exist between the U.S. and the developing world, even for skilled labor. Thirdly, recent geopolitical and military actions show how difficult it will be for the U.S. to withdraw from its role as a global policeman and focus instead on its domestic priorities. It seems that President Trump's approach to his America-first program and the wholesale cut to U.S. defense expenditures that would be required to fund domestic stimulus, tax cuts, and infrastructure and, at the same time, maintain entitlements appear to be extinguished even before his first one hundred days in office, and it seems very unlikely that he seeks a conflict down the road with the so-called military-industrial complex and the Washington political class given his fascination with selecting flag level officers as his confidants thus far. Fourthly, Trump's proposed ban and other restrictions on immigration, legal and illegal, contributes to the secular headwinds against growth.

There are two key drivers of economic activity, one is population growth, and the second is productivity growth. The reason population growth is so important is that population is the labor force that potentially produces things. Without people to produce things, you also don't have as many people to spend on things. Also, from 1982 through 2002, the number of people entering their peak savings years was increasing every year as the baby boomers were in their peak earnings and savings years, resulting in a continuously increasing demand for securities. Since the native-born population is not growing as fast as it used to, barring an unprecedented increase in productivity, and the fact that baby boomers will now be divesting securities, the secular headwinds seem as strong as ever and the opposite of when Ronald Reagan took office. Last and perhaps most importantly, the stock market as a whole is in our opinion overvalued by about 30% and, after having driven valuations to their current extremes on the basis of ultra-low interest rates, the Wall Street consensus script has been replaced and it's now higher growth that will enable valuations to be extended further, despite rising interest rates. With the financialization of the U.S. economy over the past two decades, we cannot conceive that a poor stock market will not impact and have a tautological impact on confidence and the economy, even though the policies geared to improving the domestic economy by nature have historically contributed to a poor stock market.

So, given the above and our intermediate-term expectations of difficult conditions for financial assets in general, what are the investment opportunities for capital growth aside from focusing solely on protection of capital?

- We continue to trim and eliminate stock positions within the "stable growth" area of the market, namely consumer staples and healthcare. To us, summer of 2016 represented the euphoric top in these types of stocks and the nadir of bond yields that contributed to their extended valuations. The Fund's sale of its holdings in General Mills, Phillip Morris, Nike, Colgate, SJ Smucker, and other similar companies on valuation concerns seem prescient in hindsight and, as with the original Nifty-Fifty, stable growth loses its luster in an environment of rising growth, inflation, and interest rates which we expect.
- Our significant exposure to "innovation," namely NVidia, Alphabet, Facebook, and Amazon, remains intact and has been and will likely continue to be supplemented with more cyclical technology companies such as KLA-Tencor, Corning, Adobe, and Applied Materials.
- After getting caught flat footed on "financials" at the time of the election, we see some fundamental improvement in the domestically focused regional banks as net interest rate margins improve and some alleviation of regulatory burdens will accrue to them, more so than to money center and financial market sensitive investment banks.
- Within the "resource" industries, including energy, we have lessened our hard negative posture that was based on undisciplined capital spending and production but believe that more measured future production increases will benefit workers and debtholders over shareholders in these industries mainly but certain companies, such as Noble and Williams, hold unique assets or attributes making them attractive investments in an area otherwise dependent upon a steep increase in oil prices, which we do not foresee.
- Within traditional "cyclical" areas of the market, our current preference is towards the consumer over industrials as we prefer to be exposed positively to the quality of employment and wages derived from an improved economic environment and Trump's growth agenda. Also, we've witnessed many companies in the consumer cyclical sector undertake far reaching and efficacious restructurings of their operations during the growth slowdown over the past two years, examples being Coach, Whole Foods, Carnival, and Nordstrom, with ample room for margins to expand further and attractive valuations relative to other areas of the market.

As we progress further into 2017 and beyond, despite our bottom-up optimism for the companies owned currently by the Fund, we are less enthusiastic about the prospects for capital gains in U.S. stocks as a whole. We forecast that fiscal policy potentially will replace monetary policy as the favored means of economic stimulus but are by no means assured that the transition will be a smooth one or helpful for investment securities. Also, with capital protection from traditional diversification ebbing, we believe that our pragmatic large capitalization valuation sensitive growth and concentrated, high-conviction approach to stock selection, with a cognizance of risk management that includes tactically implementing capital protective investments, seems positioned to perform well relative to less risk aware strategies within a balanced overall portfolio.

James A. Abate, MBA, CFA, CPA
Fund Manager – Centre American Select Equity Fund
Managing Director & Chief Investment Officer
Centre Asset Management, LLC

Definitions

1. Operating Leverage is a measurement of the degree to which a firm or project incurs a combination of fixed and variable costs. A business that makes sales providing a very high gross margin and fewer fixed costs and variable costs has much leverage. Gross Margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services it sells.
2. Nifty-Fifty is the 50 stocks that were most favored by institutional investors in the 1960s and 1970s. Companies in this group were usually characterized by consistent earnings growth and high price-to-earnings ratios. Price-to-earnings ratio is a ratio for valuing a company that measures its current share price relative to its per-share earnings.
3. Inflation is a sustained increase in the general level of prices for goods and services in a county, and is measured as an annual percentage change.
4. Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.
5. Net Interest Margin is a ratio that measures how successful a firm is at investing its funds in comparison to the expenses on the same investments. It typically refers to a bank or investment firm that would invest depositors money, allowing for an interest margin between what is paid to the bank's client and what is made from the borrower of the funds.
6. Monetary Policy consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of

money banks are required to keep in the vault (bank reserves).

Disclosures

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing.

To obtain a prospectus containing this and other information, please call 1-855-298 4236 or download the file from www.centrefunds.com. Read the prospectus carefully before you invest.

There is no assurance that this investment philosophy will consistently lead to successful investing. An Investment in the Funds involves risk, including loss of principal. The Fund is subject to risks including undervalued securities risk, portfolio turnover risk (which may result in tax consequences), and political/economic risk. Funds focusing on a single sector may experience greater price volatility.

Diversification does not eliminate the risk of experiencing investment losses.

The statements and opinions expressed are those of James A. Abate as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in the securities mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.

Centre Funds are distributed by ALPS Distributors, Inc. Centre Asset Management, LLC is not affiliated to ALPS Distributors, Inc.

The content of this document is part of the Centre Funds semi-annual report covering the six-month period ending March 31, 2017.

Top 10 Holdings – As of 3/31/2017 (subject to change)
Apple, Inc. 5.9%
Microsoft Corp. 4.7%
Amazon.com, Inc. 4.5%
Facebook, Inc., Class A 4.4%
Johnson & Johnson 3.0%
UnitedHealth Group, Inc. 3.0%
Adobe Systems, Inc. 2.9%
Alphabet, Inc., Class A 2.8%
Alphabet, Inc., Class C 2.8%
General Electric Co. 2.6%

DRX000634 Exp. 05/16/2018