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FINANCIAL TRENDS

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Stearns Financial Group

Stearns Financial is an independent wealth management firm providing investment management, financial planning, and business transition and planning services.

Financial Trends is a newsletter for our clients, allied professionals, and friends of the firm. We provide information from our extensive research network that helps better inform our readers on a variety of current and future investment, financial, and business planning areas.

SFG believes in being a strong consumer advocate for our clients, being pro-active, transparent and well-informed. Our research-driven team is constantly on the outlook for threats and opportunities for our clients that will impact them as they move toward their financial goals.

Would you like a member of your family or a friend to receive this newsletter?
Please e-mail Michele (manderson@StearnsFinancial.com) or call our office, 336-230-1811.

SFG Chess Set Collection: Karin Rashid, World Renowned Artist/Designer.

WELCOME to our SUMMER 2016 issue of *Financial Trends*.

This issue of *Financial Trends* focuses on several major economic trends that will drive the future of the investment markets as well as the U.S. and global economies. An update on the important energy trends is also included. We've attempted to keep the analysis of these important and complex trends easy to understand, but where you have questions, please reach out to us.

Glenn Joyce, CFA, CFP®, *Director of Research*

In this issue of SFG Trends:

SUPER TRENDS: Risk Assessment in a Rapidly Changing World

WARREN BUFFETT'S easy to read musings in the Berkshire Hathaway annual letter to shareholders is must reading for anyone who wants to understand the why and how of what is going on in various industries in America. He and his team are dealing with Super Trend analysis daily, trying to adapt to a fast changing world. Here is an excerpt from the recently released 2015 shareholder letter that talks about the ever present challenges of dealing with change.

Important Risks

We, like all public companies, are required by the SEC to annually catalog "risk factors" in our 10-K. I can't remember, however, an instance when reading a 10-K's "risk" section has helped me in evaluating a business.

That's not because the identified risks aren't real. The truly important risks, however, are usually well known.

Beyond that, a 10-K's catalog of risks is seldom of aid in assessing: (1) the probability of the threatening event actually occurring; (2) the range of costs if it does occur; and (3) the timing of the possible loss. A threat that will only surface 50 years from now may be a problem for society, but it is not a *financial* problem for today's investor.

Berkshire operates in more industries than any company I know of. Each of our pursuits has its own array of possible problems and opportunities. Those are easy to list but hard to evaluate: Charlie, I and our various CEOs often differ in a very major way in our calculation of the likelihood, the timing and the cost (or benefit) that may result from these possibilities.

Let me mention just a few examples. To begin with an obvious threat, BNSF, along with other **railroads,** is *certain* to lose significant coal volume over the next decade. At some point in the future – though not, in my view, for a long time – GEICO's premium volume may shrink because of **driverless cars**. This development could hurt our **auto dealerships** as well. Circulation of our **print newspapers** will continue to fall, a certainty we allowed for when purchasing them. To date, **renewables** have helped our utility operation but that could change, particularly if storage capabilities for electricity materially improve. **Online retailing** threatens the business model of our retailers and certain of our consumer brands. These potentialities are just a few of the negative possibilities facing us – but even the most casual follower of business news has long been aware of them.

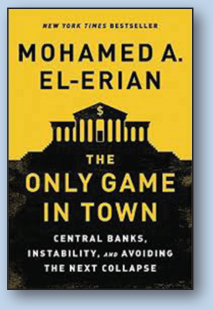
None of these problems, however, is crucial to Berkshire's long-term well-being. When we took over the company in 1965, its risks could have been encapsulated in a single sentence: "The northern textile business in which all of our capital resides is destined for recurring losses and will eventually disappear." That development, however, was no death knell. **We simply adapted. And we will continue to do so.**

– Warren Buffett

THE ONLY GAME IN TOWN

Mohamed El-Erian is considered one of the leading strategists and scenario thinkers. Trained at Cambridge and Oxford, he has worked in progressively higher positions over his career first with the International Monetary Fund, then leading the Harvard Endowment investment strategy. He was CEO and Co-Chief Investment Officer at PIMCO and is now the Chief Economic Adviser at Allianz, PIMCO's parent company. He is regularly included on multiple "Top 100 Global Thinkers" lists. In our view, he is one of the top scenario thinkers in financial and economic circles.

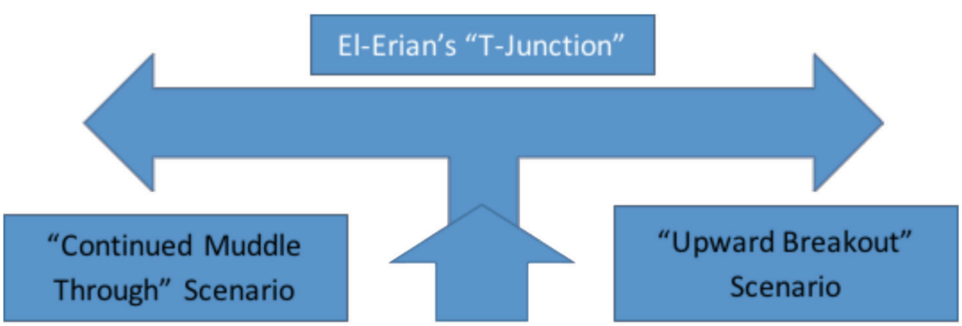
In his latest book, ***The Only Game in Town***, El-Erian makes the case for why governments have to step up to their fiscal policy responsibilities in order for their economies to break out from the "Muddle Through" experienced since the Great Recession. He contends that many governments of developed nations, including the U.S., left the economic baby at the doorstep of the central banks (Federal Reserve in the U.S.) and shirked their responsibility to help their economies grow at reasonable speeds. The time of reckoning is coming where the Central Banks can no longer be the source of fuel for economic growth.



There has long been a debate over whether the role of **fiscal policy** (economic stimulus from governments) or **monetary policy** (stimulus from Central Banks controlling money supply and attempting to control inflation and interest rates) is more important in the modern era. Few debate the fact that **a healthy economy needs both good fiscal and monetary policy** to achieve long-term growth goals without unintended consequences, like job dislocations or inflation problems.

El-Erian's Bottom Line Conclusions

- **We are coming to a fork in the road (Growing up in England and being trained at Oxford, El-Erian calls it a T-Junction) that government policy makers can impact and must get engaged to create positive change.** Time is of the essence.
- **If policy makers embrace what is needed and take decisive action** (50% chance), we can achieve more positive results than "Muddle Through" economic growth.
- **If they don't step up to the challenge** (50% chance), we're in for many more years of sub-standard growth ("Continued Muddle Through"), an anxious populace and continued political unrest.



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El-Erian's Prescriptions to Avoid the "Continued Muddle Through" Scenario

1. **Aging infrastructure must be rebuilt** – consider it the next wave of the Eisenhower infrastructure plan that gave us our excellent highway system and propelled economic growth well in excess of the cost of the new infrastructure. **SFG note:** Briefings to the presidential candidates by El-Erian and influential economists (Democrat and Republican) have resulted in both Hillary Clinton and Donald Trump suggesting the need for a major national infrastructure program. Infrastructure can include highways and bridges as well as the electrical grid and our "innovation" infrastructure.

   As we know, campaign promises and bi-partisan economist support don't guarantee an effective, robust program or a satisfactory outcome.

2. **Workers must be re-trained at a faster pace** – El-Erian acknowledges the effect of the new techno-industrial revolution which destroys jobs and creates new ones at a faster pace than similar industrial revolutions that came before.

3. **Reduce the pockets of excessive deb**t – yes, U.S. consumers have decreased their debt burden since the Great Recession, but low interest rates have fueled higher debt in other areas here and abroad.

4. **Change the U.S. corporate tax system that is riddled with anti-growth exemptions** – in a truly global world where companies can more rapidly move money and operations, corporate tax structures must reflect the realities of the 21st century.

5. **Increase global policy coordination** – It will always be true that countries primarily look out for the well-being of their own citizens. El-Erian suggests that currency and trade wars create greater economic volatility. At a time when more poverty is being eradicated around the world than any time in human history, he believes that win-win solutions exist but only if politicians have the will to take a longer view. **In our view, this may be the least likely of the five prescription items to occur.**

Given the recent dysfunction and gridlock in Washington D.C., it's natural for many to wonder if we can really prevent the Muddle Through scenario.

Strategies to Consider for the "Continued Muddle Through" Scenario

- **Assume that stocks, bonds and other investments will earn less in the next five to seven years than they have historically.** For many, this will mean "saving more, spending less" to maintain or achieve financial independence. For some it may mean living more for today and having fewer safety nets during retirement.

- **Consider more "alternative" investments to traditional cash, bonds and stocks.** SFG is already using selected alternatives such as investment grade, income producing real estate in portfolios and considering more options for our clients in case we find ourselves in prolonged Muddle Through.

- **With prolonged low investment returns, be extra careful investing in high yield alternatives.** Investors learned this lesson in 2015 when "can't lose" pipeline companies with 8% yields slashed their dividends and lost half their value. Many other unfortunate losses have occurred when investors reached for yield in areas where they didn't fully understand the risks.

- For retirees, business owners and others with higher cash flow needs, **maintain more cash reserves than normal. This is one of El-Erian's key takeaways, that despite today's low interest rates, having higher cash reserves hedges scenario risk.** Unfortunately, this will create an even bigger drag on overall investment returns in a lower return world since cash doesn't earn much these days. But having the cash will help you sleep better at night and avoid selling assets at fire sale prices if times get tougher in the Muddle Through scenario. **SFG Note:** How much cash is appropriate is unique to each client's circumstances.

- **Maintain a high level of alert in your business or career.** Sharpen your ax at every opportunity and be better at your craft. Super Trend effects on jobs that SFG has chronicled in previous editions of *Financial Trends* may be more pronounced in a Continued Muddle Through scenario. One example: public and private companies that have trouble increasing sales will try to keep profits higher by relentlessly trimming expenses, including substituting automation (technology accelerators, including robots as that technology evolves) for labor (people).

SFG Chess Set Collection: Birth of the Roman Empire, Battle of Actium, 31 BC -- Acarnuia, Greece, Caesar Octavian vs. Mark Antony and Cleopatra.

Downside Scenario

You may be thinking "there has to be a downside scenario here somewhere given the dysfunctional U.S. political system, rising debt around the world and growth stagnation." Yes, there is a scenario where growth is less than Muddle Through for the U.S. and the rest of the world. **There are a number of reasons why El-Erian believes this downside scenario is a lower probability portion of Muddle Through, perhaps a 10-15% chance of occurring.** Chief among these factors that lower the downside case are the rise of consumers around the world and that the world is also awash in cash somewhat offsetting the debt issues, which are more concentrated in emerging market countries.

While it would be a mistake to focus a strategy on a lower probability scenario, SFG has "shock absorber" assets in place to mitigate this scenario if it were to occur, as well as strategies we can employ if we see a major downturn coming which is likely to coincide with a recession.

The Good News – Why the Better Growth Scenario Has an Edge

El-Erian puts the chances of all five prescriptions being adequately implemented in the next three years at 50%. **He calls this a "bi-modal" distribution, meaning we either live with Continued Muddle Through or a big concerted effort is implemented to fix the issues that the Central Banks can't fix going forward.**

There is evidence that some of El-Erian's five prescriptions are already being implemented, just perhaps not at levels that make it highly likely that we break out of Muddle Through.

Better Scenario Considerations

- **The U.S. is still the "Big R" in Research and Development,** even though we lost our "Big D" (developing profitable solutions from the research) as we outsourced manufacturing to China and elsewhere in the early stages of Globalization 1.0 and 2.0.
  - **We can get our "Big D" back.** Companies like Apple and Google arguably already have both robust **research** <u>and</u> state-of-the-art **development** capabilities.
- **Many states and municipalities are taking infrastructure rebuilding into their own hands.**
- **Innovation in America is igniting in big cities and small towns from the grass roots up.**
  - Business incubators, accelerators and venture idea labs are doing innovative work with smart people, good tools and often, with more than adequate capital funding. The Lean Start-up methodology is widely embraced (money is helpful but not critical).
  - Americans have rarely waited for the government to help them build their business or create innovation progress. The new book, *Smartest Places on Earth*, is not only a fun read, it highlights why the U.S. has a worldwide edge in creating "Brainbelts," areas where nine harmonious factors create explosive innovation and growth.
- **Major corporations are paranoid about the effects of Super Trends converging and many are implementing extreme measures to innovate** or face becoming Eastman Kodak (bankrupt or marginalized as an effective company).

SFG TAKE:

For more information on how the forces above may impact the future in a positive way, read Dr. James Canton's excellent new book, *Future Smart*. Dr. Canton has been at the forefront of innovation and creating "Big D" opportunities around the world for several decades.

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Strategies to Consider for the "Upward Breakout" Scenario

- **Growth assets like stocks and certain kinds of real estate may do better in this scenario.** Interest rates may rise and normalize faster here, so traditional bonds may have more early headwinds. As bonds provide more competitive returns in the 5-7% range (not expected in this scenario for three to five years), some stocks will become more volatile, especially those companies that are not keeping up with the changing world. Investment grade real estate may begin to struggle as interest rates normalize, especially for properties with shorter term fixed interest rates on debt and in areas of the real estate market that have become overheated.

- **Consider your debt levels and financing terms** – if you added debt in the time of low interest rates, have plans for lowering debt or locking in interest rates on existing debt. The good news here is most Americans have already refinanced their home loans into lower, long-term fixed rate mortgages.

- **Accelerating innovation is also a concern in this scenario** – we are coming into a time where most scenarios carry with them threats to your job. Whether it's the rise of cloud enabled robots envisioned in the excellent new book, ***Industries of the Future***, or companies implementing better efficiencies in their operations, figure out ways to be better at what you do and indispensable to your customers.

SFG Chess Set Collection: Birth of the Roman Empire, Battle of Actium, 31 BC -- Acarnuia, Greece, Caesar Octavian vs. Mark Antony and Cleopatra.

Investment Strategy

On the right, is an example of an investment scenario grid that SFG developed to consider the impact of the two El-Erian scenarios on our clients' investments. At this stage, it is more of a blunt instrument than a precise surgical tool. El-Erian has suggested "playing the movie" with different investment approaches and not getting too bogged down in the weeds trying to guess the precise movements of various investments as the scenarios unfold. Instead, **the prescription is to have a good understanding of the forces that will push and pull on different investments, be agile and adjust strategies along the way.**

El-Erian has been a master of agile execution when he has found himself in one of the movies that he and his team have play tested. **He considers this "pivoting" skill much more important than trying to predict in advance which scenario will actually occur.**

Since SFG believes it will be very difficult to predict the exact scenario going forward (it almost always is!), it is best to settle on a reasonable allocation using traditional valuation and risk measures that fit each person's or entity's unique circumstances and then adjust or "pivot" as more evidence of the future trajectory becomes clear.

Investment Scenarios

Asset Classes (60% stock /20% bond / 20% alternative portfolio)		Muddle Through Rating	Upward Breakout Rating
Cash		**B+**	**C**
Bonds	• Core • Explore	B C	D C
U.S. Stocks	• Core • Explore	C B	B A-
Int'l Stocks	• Core • Explore	D+ C-	C B
Alternatives	• Core • Explore	B B	C C
Average grade (by asset class weight)		**C**	**B**

This chart shows how each asset class may behave in different scenarios, and it's clear that different assets perform in different ways in the slow growth "Continued Muddle Through" scenario versus the growth recovery "Upward Breakout" scenario.

For example, you'll notice that "Bonds, Core," which are the highest quality government, corporate or tax-free municipal bonds, have a "B" rating under the Muddle Through scenario. In this scenario, interest rates rise slowly and there are more "Brexit-type" shocks, which makes these highest quality bonds more attractive than stuffing cash in the mattress despite low yields and potential future headwinds. In the Upward Breakout scenario, they have a "D" rating. This is due to it being more likely that interest rates will rise faster in this scenario, creating even lower returns (possibly even negative returns in some years) for many of these types of bonds.

Another example is "Explore-type" stocks (less indexed, active-type management) which get a "B" rating in the Muddle Through scenario due to their ability to be more agile in this scenario, avoiding threats and taking advantage of opportunities. "Core-type" stocks only get a "C" rating in Muddle Through – index-type stocks and stock funds (SFG's favorite in the first stage of the bull market) may struggle in Muddle Through given current valuations and market forces.

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INVESTMENT TRENDS, *continued from page 7*

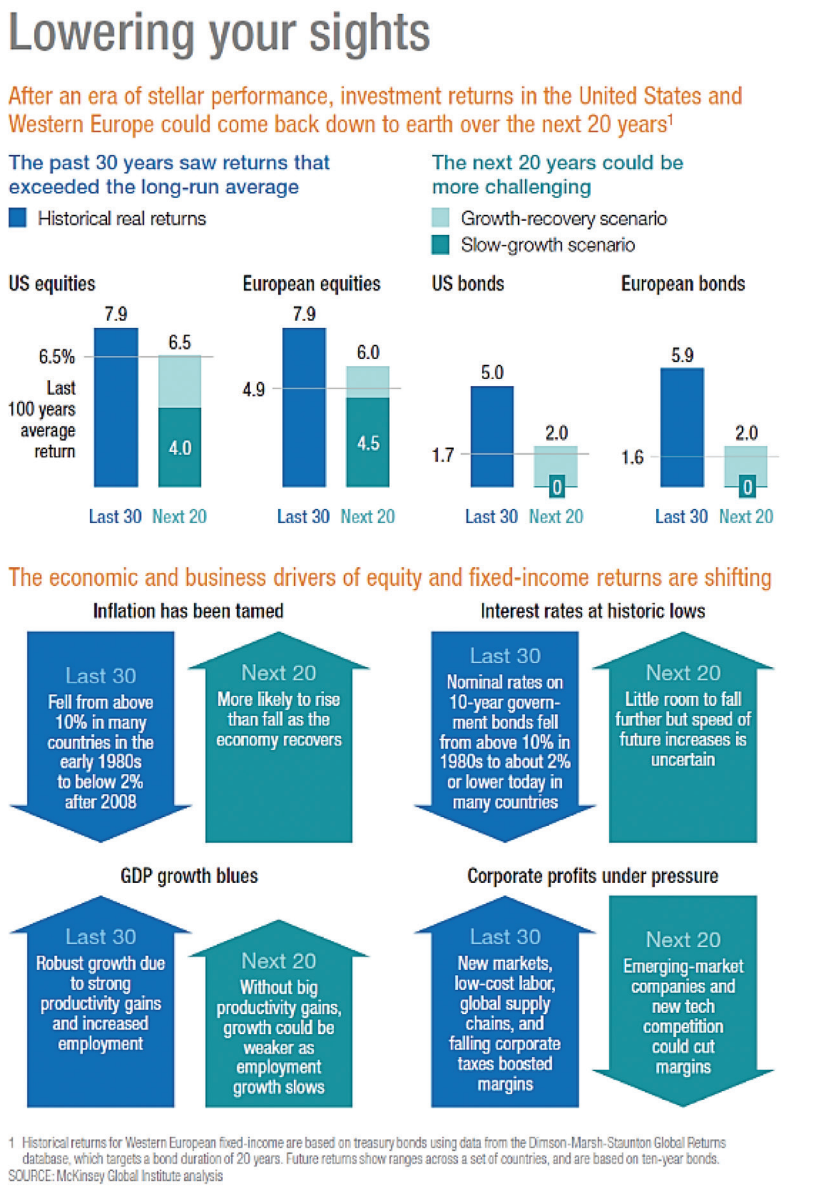
As SFG has been discussing in our quarterly podcasts and special reports, it's wise to assume lower returns going forward than in the last few decades in both El-Erian scenarios. **However, there will be opportunities to enhance future returns without taking dramatically more risk in both the slow growth scenario and the growth recovery scenario.**

The chart to the right provides McKinsey's forecasts for different types of investments in a Continued Muddle Through (slow growth) versus Upward Breakout (growth recovery) scenario. **Note that all returns are expressed as "real" after inflation, so you can add 2-3% to these numbers for the pre-inflation annual returns forecast.**

One of SFG's future goals is to equal or better these forecasts while avoiding mistakes that might negatively impact future outcomes.

You might also consider the return forecasts (shown on the right) to be "market" or "index" returns. El-Erian believes that **balancing index fund strategies with more active management approaches** may be a key to enhancing investment returns, even as we prepare for a lower overall return environment.

A number of prominent "indexing" advocates have suggested this more balanced approach may do better now that we are out of the first major phase of the bull market. **Fortunately, this balance of indexing and active strategies is already a core strength at SFG.**



SFG'S TAKE: El-Erian knew he would create furrowed brows when he gave the two main scenarios a 50/50 chance of coming true. He believes it's better to understand what they need to do in the alterative scenarios than to try and guess which one will come true. This is part of his three part solution to survive this coming period and prosper: 1) **Optionality** (fancy term for scenario thinking), 2) **Resilience** ("play the movie" in each scenario and stay cool as major Super Trend forces collide around you) and 3) **Agility** (adjust your personal and professional planning as the scenario path becomes clearer).

At this stage, SFG has as many questions about how these scenarios will unfold as we have potential strategies. We're "playing the movie" and becoming hyper-attuned to the scenario drivers so we can hopefully make better investment and planning decisions for our clients in the coming years.

As Warren Buffett ends his shareholder letter excerpt quoted earlier in this *Financial Trends* newsletter, **We simply adapted. And we will continue to do so.**

FREQUENTLY ASKED QUESTIONS
about the El-Erian "Bi-Modal" Scenarios

INVESTING:

Q: Why are there no "A"s in your risk/reward ratings for investments for either El-Erian scenario?

A: Given today's valuations that are at or above fair value for most investment categories, the next three to five years will likely have lower absolute and risk adjusted returns than the previous five years. SFG will still be watching for "A" level opportunities to add to more attractive investments as markets get mispriced by the swing of "animal spirits" (investor confidence) from time to time.

Q: Your two scenario El-Erian investment grading model is for a growth and income, 60/40 investor. For a growth investor, will SFG be concentrating investments in areas rated "B" or better?

A: It depends on the risk level of the growth investor. Moderate risk growth investors or investors with higher potential withdrawal rates will still want lower rated categories that may also reduce downside risk. An example would be core high quality bonds – they may return little above inflation in the next three to five years, but they are a preferred safe haven in the event of economic or geo-political shocks.

Aggressive growth clients with a higher appetite for risk will be concentrated more in better rated areas (now and future "fat pitch" opportunities).

Q: Are the El-Erian factors more important to future investing than traditional revenue and profit capabilities of individual companies? More important than Super Trend forces?

A: Cash flow, profit growth and sustained competitive advantages are ultimately the top predictors of future investment success or failure. The El-Erian scenarios are important to the investment prospects for many stocks and investment real estate holdings due to both reality (how cash flow will perform) and perception of reality (how "animal spirits" value the cash flow created). Traditional revenue and profit measures for many companies would be more positive if government fiscal policy functioned well. Meanwhile, investors would be more willing to participate in growth investments if they had more confidence in future growth.

Super Trend forces continue to be a major factor in economics, politics and investment scenarios going forward. **For example, if a company has poor leadership and isn't keeping up with the innovation or globalization changes to its marketplace, the El-Erian "Upside Breakout" scenario may not materially change their prospects going forward.**

RETIREMENT PLANNING:

Q: How should someone soon approaching retirement or already retired think about these scenarios?

A: Lower than normal investment returns for at least three to five years should be part of plan assumptions. But this is what SFG is already assuming even without the El-Erian scenarios as a result of the good gains achieved in growth assets the last five years and the headwinds that rising interest rates will eventually create.

For some retirees with higher spending needs and/or without a good cushion of assets, if it looks like the "Continued Muddle Through" scenario will be with us for a while, being a bit more conservative in retirement withdrawal rates early on may be prudent. For others where it's more likely spending will be modest or even decline in later years, today's spending may not need adjustments.

Every situation has unique circumstances – SFG can help you consider if any changes are needed to your basic game plan as a result of the El-Erian scenarios.

ECONOMY AND GENERAL QUESTIONS:

Q: What are the chances that El-Erian is right but actual events unfold somewhere between his "Continued Muddle Through" and "Upside Breakout" scenarios?

A: The foundation of scenario learning is if you get the assumptions in a scenario exactly right, you're very lucky. **El-Erian is an excellent scenario planner but he acknowledges that no one, including himself and his team, has a magic crystal ball.** The push and pull of political, geo-political and Super Trend forces have created numerous complexities in today's world – layering on the El-Erian scenarios creates even more uncertainty.

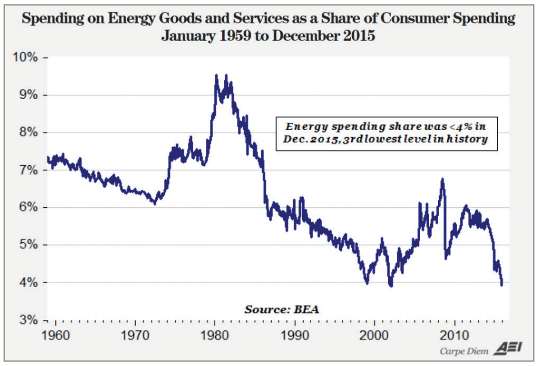
While we're somewhat confident we won't find ourselves at the bottom end of the "Continued Muddle Through" scenario, we're equally confident that government policy makers are having difficulty keeping up with the changes in our world and will not be able to fully enact El-Erian's five prescriptions.

Q: How would a new war between Iran and the Saudis, or some other major conflict, affect the El-Erian scenarios?

A: Any major geo-political event will have a major impact on either the Upside Breakout or Continued Muddle Through scenarios. **The Upside Breakout scenario** creates more prosperity and stability to higher oil prices that make armed conflict in some parts of the world less likely.

ENERGY UPDATE

U.S. consumer spending on energy goods and services fell to 3.9% in December. **In the last 55 years, this is at the low end of "energy spending share."**



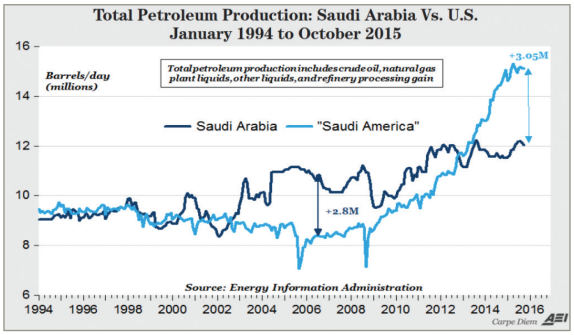
Cutting the price of petroleum enables consumers to travel, eat, and buy goods more cheaply, which leaves consumers with more money to spend on other things, which in turn creates jobs supplying those needs.

In mid-2014, crude oil prices averaged just over $100 a barrel, depending on which grade you wanted to buy. At the end of February 2016, prices hovered near $30. That's roughly a 70% decline. The total value of all the world's oil reserves is *over $100 trillion* less than it was just a year and a half ago. **No wonder stock and bond markets have been under pressure as sovereign wealth funds of nations around the globe liquidate securities to cover shortfalls created by this evaporation of net worth.**

Since mid-2014, the collapse in the oil price has already transferred over $2 trillion from petroleum producers to petroleum consumers, worldwide. Petroleum is the largest and most indispensable commodity on which society currently depends. **The value of the petroleum produced every year exceeds the value of natural gas, coal, iron ore, wheat, copper, and cotton combined.**

The Price of Oil, by Roberto Aguilera and Marian Radetzki, predicts that this energy revolution has a long way to go. The current low oil price is bankrupting many producers and explorers and many rigs are now standing idle. Yet there has only been a very modest fall in production as a result of the improvement in technology for extracting oil.

Every year, it takes fewer rigs to generate more oil and, as with so many disruptive Super Trend technologies, **this benefits the consumer more than the inventors.**



Aguilera and Radetzki argue there is another energy revolution on the way. When the price is right, conventional oil fields can now be re-drilled with the new techniques developed for shale, producing another surge of oil supply from fields once thought depleted. Other countries are now adapting the technologies that drove U.S. oil and natural gas production higher.

Why is the price of oil so volatile? Aguilera and Radetzki make the case that depletion has never been much of a factor in driving oil prices, despite the reduction in production in some oil fields (the North Sea is now experiencing this). OPEC's interventions intended "to fix" prices didn't make much difference over the long run. **What caused the price of oil to rise much faster and more erratically than other commodities was a shift in the geopolitical control of the resources.**

There was a wave of nationalization in the oil industry beginning in the 1960s. Today, nationalized companies hold some 90% of conventional oil reserves. ExxonMobil and BP are small players compared with the oil companies controlled by the governments of Saudi Arabia, Venezuela, Iran, Iraq, Kuwait, the United Arab Emirates, Nigeria, and Russia.

Post-colonial nationalization affected many resource-based industries, but whereas many poorly run mineral and metal companies were privatized in the 1990s, the same has not happened to state oil companies. The consequence is that most oil is produced by companies that are **milked by politicians, and**

SFG Chess Set Collection: Great Indian Desert, The Golden Citadel, Medieval trade route - Jaisalmer, India.

starved of incentives for innovation and productivity. This created a good opportunity for disruption by new entrepreneurial players operating on private lands with private capital.

SFG's take: Technology accelerators have permanently transformed the economics of the oil industry, both on the conservation side and the production side. Whenever oil rises above $50 a barrel as a result of rising demand, large new quantities of oil from newly exploited shale deposits and the rehabilitation of old conventional wells will likely flood the market.

Meanwhile, alternative energy sources continue to grow despite low oil prices. New breakthroughs in fuel cells, solar, wind, geothermal and other areas are happening regularly, suggesting the potential for these cleaner energy sources to begin to erode oil's dominance in the world within the next 10 years. Breakthrough alternative research is also advancing in the nuclear fusion and methane hydrate areas.

Some industry experts (who are objective analysts and are not paid by either energy camp) believe alternative fuel sources will represent over half of power generation and consumption within 25 years.

Today, the average consumer only spends 3.9% on energy, although the cost of energy is included in everything from clothes to food to manufactured goods. Other than occasional energy disruptions caused by bad actor nation states around the world, **there is a good chance that we will rarely see energy costs rise as a material percent of both individual and company budgets in coming decades.**

VUCA Virus More Virulent than Zika Virus

The Zika virus caused by the Aedes species mosquito has been all over the news lately. According to the U.S. Center for Disease Control, as of June 1, there have been 618 reported cases of Zika from people who travelled to affected areas. There have been zero cases where it was acquired in the U.S. Affected patients usually don't get sick enough to go to the hospital and rarely die.

The VUCA virus is much more virulent and is trending dangerously higher. VUCA stands for Volatility, Uncertainty, Complexity and Ambiguity. VUCA is a symptom of a fast paced, Super Trend world with anxiety fueled by rapid change combined with the 24/7 crisis du jour media. It is estimated that at least one in three Americans are experiencing heightened anxiety and stress related illnesses caused by the VUCA virus.

VUCA VIRUS PREVENTION:

1. Build your resistance to VUCA by better understanding your financial position and planning options.

2. A healthy lifestyle, including regular exercise, even walking just 20 minutes three times every week, can help relieve VUCA symptoms.

3. Avoid VUCA virus carriers – spend your time around positive people who have a good attitude and stable mental health.

4. Unplug from VUCA virus transmitters as needed, including TV, newspapers, radio and internet conspiracy theorists.

5. A grateful attitude for what you have, versus fretting about what you don't have, is a key ingredient in reducing VUCA related stress disorders.

FUTURE SCENARIOS: Globalization 3.0

EXECUTIVE SUMMARY

- **We have had global trade for centuries, but it has accelerated more in recent times than ever before.** The globalization trend accelerated rapidly in the 1980s and was a major economic growth catalyst for nearly two decades, breaking through many traditional cross-border barriers and spreading wealth across the world in an unprecedented manner.
- While it evolved several times during its two decade rapid ascent, **the financial crisis of 2008-2009 left global trade stagnant and reflective of the "Muddle Through" economy seen in both the U.S. and overseas.**
- **The speed at which innovation, emerging and frontier markets, economic stagnation, isolationism and global conflict are colliding will have a profound impact on the next phase of global trade, Globalization 3.0.** This new phase contains both great opportunities and significant threats to U.S. and overseas investments.
- **Globalization 3.0 will likely create ever greater stress within political parties around the globe.** It is questionable whether governments can be agile enough (given political realities and bureaucracies) to respond well to both the fast pace and high degree of change that is coming.
- Brexit-type decisions, a "no confidence" vote for globalization, will become more frequent all around the globe. See SFG's Special *Poolside Chat* on Brexit scenarios.

Globalization is one of the more powerful and controversial of the Super Trends. A recent AP poll found that 67% of Americans would buy a foreign made pair of blue jeans at $50, rather than a U.S. made pair at $85, assuming equal quality and styling in both pairs.

Americans understand at one level that globalization has improved their quality of life. They also understand that there is a dark side of the globalization force, the hollowing out of the U.S. middle class (along with technology accelerator forces) and persistent income inequality.

The A.T. Kearney Global Business Policy Council recently provided some interesting texture to a complex topic: **where will globalization shift from here?** The answer has ties to the two El-Erian economic scenarios for the U.S. profiled in this newsletter.

International economic interactions, the cross-border movement of goods, services, capital, and people, accelerated after the end of the Cold War in the early 1990s. As former Soviet bloc countries and China liberalized their economies and integrated into the U.S.-led global economic system, they powered globalization as never before in modern times.

After decades of a global economy partitioned into separate blocs global trade grew by 85% and Foreign Direct Investment flows rose by an astonishing 580% in the ensuing decade. This 1989-2000 period is referred to as **Globalization 1.0.**

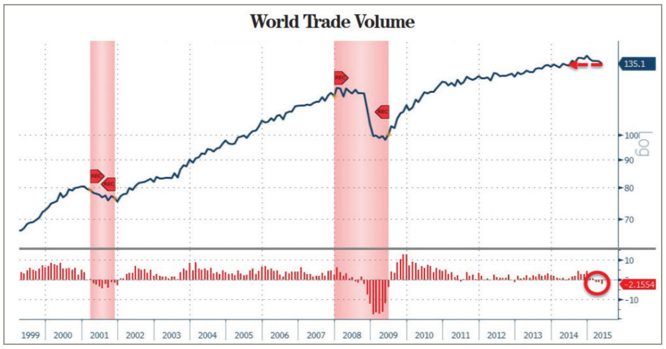
The period beginning in 2001 and leading up to the 2008-2009 global financial crisis is termed **Globalization 2.0**. In this stage, the cross-border movements of goods, services, capital, and people seemed to be on an ever-upward trajectory. Globalization declined temporarily following the U.S. dot-com crash of 2000 and the attacks of September 11, 2001.

However, it rebounded relatively rapidly throughout the rest of the 2000s on the back of strong growth and international integration of the emerging market economies.

Globalization is a key factor in today's political instability and income inequality.

*"The right (in politics) has no good answer to the problem that globalization **erodes people's identities.** The left has no good answer to the problem that globalization **exacerbates inequality**."*

– David Miliband, *Former British Foreign Minister*



Source: A.T. Kearney, Globalization to Islandization.

By 2007-2008, global trade flows had hit an all-time high of 64.3% of global GDP, and Foreign Direct Investment inflows had reached an apex of over $2.2 trillion. Global portfolio investment flows were also far above their historical average, at almost 2% of global GDP in 2005 and 2006.

The 2008-2009 global financial crisis and subsequent Great Recession proved more disruptive to globalization than any previous challenge. The U.S. subprime mortgage crisis that nearly caused the American financial sector to collapse and created tsunami waves in financial and housing markets around the world was not only detrimental to global economic output, but also to the intercountry economic linkages essential to globalization. As a result, all major economic indicators of globalization fell during that period — both in absolute terms and as a share of global GDP.

After contracting in 2009, the global economy returned to growth in 2010 thanks in large part to the economic strength of emerging markets, and in particular to China. The emerging markets were less affected by the global financial crisis than were developed markets; as a group, they maintained a positive GDP growth rate of 3% in 2009 while developed markets saw their economies shrink by 3% in the same year.

The recent emerging market slowdown, coupled with the continued low-growth environment in most developed markets, makes it clear that when the global economy hit bottom in 2009, it entered a *new* phase in which the **march of globalization has slowed to around 2%.** This compares to almost 3% during the Globalization 1.0 and Globalization 2.0 phases.

The current global economic order is underpinned by five new forces that are reshaping the global business environment. Two of these new forces are the result of developments that arose during prior periods of globalization and which laid the groundwork for the current doldrums. The other three are independent forces that have arisen in the post-crisis period, defining new rules-of-the-road for global companies.

FIVE FORCES RESHAPING GLOBAL BUSINESS

THE FIRST NEW FORCE is increased prosperity. Vast numbers of people in emerging and frontier markets have been pulled into the global workforce and the prosperity of households in many emerging markets has increased dramatically.

Many formerly low-wage manufacturing markets have developed economically and achieved higher income levels, meaning wages are now higher too. There is evidence to suggest that higher labor costs in such markets are increasingly driving businesses to locate production facilities closer to home, creating the American "re-shoring" trend discussed in previous SFG newsletters. As more production takes place in home markets, the flow of international trade in goods slows.

THE SECOND FORCE is the rise of the knowledge economy. Thanks to technological advancements in recent years, knowledge-based capital has become much more important. This includes:

- Computerized information such as databases and software
- Innovative property like copyrights, R&D, and patents
- Economic competencies including management know-how and brand building

Led by innovation and growth in technology and human capital, the knowledge economy took center stage in the late 1990s and early 2000s. Knowledge-based capital investment in OECD (Organization for Economic Cooperation and Development) countries exceeded the investment in physical capital (machinery and vehicles) for the first time in 1997; and it has been increasing at a high rate ever since.

An interesting paradox: the rise of the knowledge economy seems to have reduced global trade in goods. Increasingly sophisticated industrial robots erode the business case for outsourcing production to lower-wage markets because fewer workers are needed to run factory

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operations wherever they are located. Similarly, the upsurge of additive manufacturing or 3D printing is already lowering the incentive for companies to locate their manufacturing operations overseas, a trend that will accelerate as the technology advances and decreases in cost. **Amazon, General Electric, UPS and hundreds of other blue chip companies are stepping up their experimentation with 3D printing technology to meet growing consumer demand for rapid delivery of highly personalized goods.**

The knowledge economy is also **boosting international services** trade. Technology accelerators and the internet have enabled the growth of the business-to-business services trade in recent years, making outsourcing widely available to even medium-sized and smaller companies.

THE THIRD FORCE is persistent macroeconomic stagnation. Over the past 18 months, the IMF, World Bank, and G20 have voiced concern about long-term prospects for global economic growth and prosperity. Most major developed markets continue to underperform, and there is growing unease about weakness and volatility in emerging markets. In particular, declining momentum in China, modest growth in the United States, and a sluggish, uneven recovery in Europe are weighing heavily on the global economy.

El-Erian's prescription for government leaders (described earlier) would help improve this key factor.

The number one reason for lower foreign direct investment flows is a **lack of confidence in the macroeconomic outlook.** This uncertainty is likely also affecting the nature of cross-border portfolio investment flows. Given business leaders' concerns about the stability of the macroeconomic environment, it is hardly surprising that developed markets continue to receive such a large share of global portfolio flows.

THE FOURTH FORCE relates to the return of geopolitical confrontation. Geopolitical tensions have negative economic implications not only for those markets that are directly involved in geopolitical disputes, but also for their neighbors, as well as the regional and global economy. Key geopolitical hotspots today include Russia and Eastern Europe, East Asia, and the Middle East.

The return of geopolitical tension is having a complicated effect on globalization. Geopolitical tensions are reducing cross-border trade and investment flows. Geopolitical instability is also accelerating the cross-border flow of people. The Syrian civil war alone has displaced more than seven million people internally and more than four million internationally. Flows of refugees are fundamentally different from those of economic migrants, who tend to arrive in more easily manageable numbers and have more resources with which to start a life in their new homes.

THE FIFTH FORCE is heightened nationalism and protectionism. Market liberalization and economic integration, carried out by countries looking to reap the benefits of connected global supply chains during times of global economic expansion, can also generate tensions when economic activity slows and governments seek ways to improve local economic

SFG Chess Set Collection: Eighth Wonder of the World, First Chinese Emperor Quin's Terra Cotta Army, Xian, China.

performance. After decades of agreeing to lower global barriers on a host of economic interactions, countries are now increasingly establishing new obstacles to cross-border activity, including financial regulations, rules governing the internet, immigration restrictions, and trade barriers.

Many developed economies continue to face low or stagnant domestic economic growth, high unemployment, and a growing income inequality gap. Developed economy governments have struggled to raise middle-class incomes and create middle-class jobs. **Income inequality driven by competition from overseas workers and new technologies has resulted in anxiety that is fueling inward-looking politics and nationalism.**

In Europe, these economic and social challenges have resulted in the rise of radical parties on the left and right, while in the United States they have resulted in polarization and gridlock. The growing popularity of "outsider" or fringe candidates and political parties in democracies around the world is a response to popular sentiment that the global economic order is not meeting people's expectations for rising prosperity.

With the rise in nationalism, governments are responding with protectionist measures – including stricter trade regulations, tighter foreign investment policies, and competitive currency devaluations – to achieve various macroeconomic and geopolitical goals. For instance, by the OECD's count G20 economies have implemented 1,244 new restrictive trade measures since the global financial crisis, only 282 of which have since been lifted.

As El-Erian has pointed out, nationalist and protectionist attitudes and policies are clogging the engines of globalization. They reduce international trade and investment flows, as a result of both specific policies that prevent such transactions and shifting consumer preferences that make expansion into foreign markets a less appealing business case. At the same time, more nationalist attitudes are likely to reduce the lure of international migration, as migrants would feel unwelcome and may face discrimination and violence in some countries.

Given these trends, it is no wonder that an increasing number of multinational corporations are hiring political scientists, starting their board meetings with geopolitical briefings, and seeking the advice of former diplomats, spymasters and military leaders.

REALITY CHECK: *How Will the United States Fare in Globalization 3.0?*

One thing that Bernie Sanders and Donald Trump agree on is that the older U.S. trade agreements like the North American Free Trade Agreement (NAFTA) to the new Trans-Pacific Partnership trade accord (Hillary Clinton also opposes Obama on this agreement) should be voted down, renegotiated or scrapped altogether. Loss of U.S. jobs is the primary reason for this rhetoric, but we know from past history that protectionism medicine has many bad side effects, including the unintended consequence of destroying other U.S. jobs as global trade declines.

In *The Truth About Trade* (July/August 2016 edition, *Foreign Affairs*), a strong case is made that technology advances are more the culprit than globalization in hollowing out the middle class in the U.S., U.K. and many other developed nations. For any politician to say they can reverse these super trends is hubris – they might be able to slow them down, but the costs and unintended consequences of those actions may be more unpleasant than any gains made.

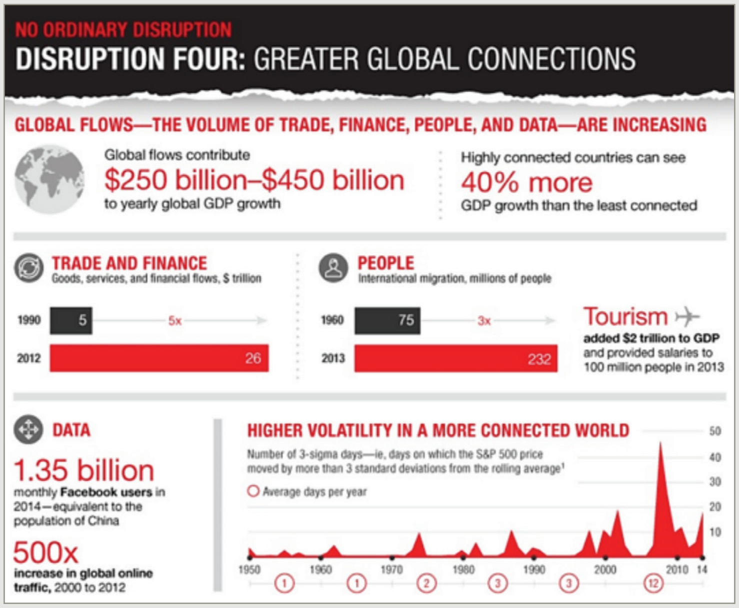
The U.S. has a number of factors in its favor to succeed in Globalization 3.0. The McKinsey Global Institute reports that global flows of goods and services declined from 53% in 2007 to 39% in 2014 not just because of the Great Recession and lower dependence in the U.S. on importing foreign oil. They also cited **"the cost of managing complex, lengthy supply chains"** as a reason many companies are looking for manufacturing solutions back at home or at least closer to their home base.

This is where the potential for the North American trade block (Canada, Mexico and the U.S.) becomes very intriguing. As outlined in ***Accidental Superpower*** (previously profiled in a SFG *Fireside Chat*), the United States has more waterways allowing commerce than the rest of the world combined, which has contributed to the U.S.'s meteoric economic rise.

In the new book, ***Connectography: Mapping the Future of Global Civilization***, the author continues this trend discussion. North America has slowly been wiring its infrastructure together with railroads, pipelines, electrical grids and trading pathways. The potential for this union to become even more powerful in the Globalization 3.0 phase is significant. This is yet another factor that favors the U.S. eventually breaking out of "Muddle Through" mode, although a bit of coherent government help (as outlined by El-Erian) would increase the odds of U.S. success in a world where many countries have more options for trading partners than ever before.

DID YOU KNOW? U.S. manufacturing employment of 12.3 million workers is down 37% from the peak of 19.5 million reached in 1979. When did the value of manufacturing output hit its peak? The answer may surprise you: today!

The current level of U.S. manufacturing output is in the vicinity of the all-time high and roughly double the 1979 level. Twice the output with less than two-thirds the workers means output per worker has more than tripled. Thus, if we were producing today's output at the 1979 level of productivity, we'd be employing 25 million more workers! While we've lost 3.2 million jobs to China since 2001, we've lost many times that to improvements in productivity. The early 19th-century Luddites, English textile workers who were unhappy about industrialization, banded together to destroy labor-saving factory machinery. History shows it's hard to hold back economic progress by edict or force of will.



Source: No Ordinary Disruption

SFG'S TAKE: El-Erian's three keys for surviving and prospering discussed earlier in this *Financial Trends* newsletter, **Optionality, Resilience and Agility,** will be fire tested in Globalization 3.0. Business leaders will be challenged like never before to navigate the complex global scenarios that lie ahead. In addition to traditional investment valuation tools that SFG uses like stock price relative to earnings, free cash flow, and dividend yield and growth rate, **preferred multinational stocks should have strong leadership teams** and **wide, expanding "moats"** (see SFG *Financial Trends* Winter 2015). Even this won't guarantee investment success so **diversification** among multinational companies and **balanced alternative growth and income assets** remain important tools in a world of accelerating change.

Stearns Financial NEWS OF INTEREST

- **Stearns Financial Group was awarded the *Financial Times* Top 300 Independent Advisors in 2016, the third year in a row that SFG has achieved this distinction**. Stearns Financial is the only firm in the central region of North Carolina and one of only a handful in the nation that has earned the Top 300 designation for three consecutive years.

- Dennis spoke at the prestigious FPA NorCal conference in San Francisco on **"Red Team Exercise: 3000 Times the Impact: The Powerful Trends That Will Impact Your Portfolio and Your Life,"** a summary of Super Trend (convergence of Technology Accelerators, Globalization, Global Age Wave and Global Urbanization trends) and the two El-Erian economic scenarios for top professional investors and planners.

- SFG hosted **Creating Transferable Value in Your Business**, a business leader workshop on Super Trend forces affecting business strategies, business sale and transition updates and how the Traction/Entrepreneurial Operating System (EOS) can help private businesses become more efficient and effective in this rapidly changing world. Jill Young was our special guest speaker from Traction First in Dallas. EOS is described in detail in the book *Traction* by Gino Wickman.

SFG clients can request copies of either of these presentations.

- **Interested in a consultation on how the El-Erian scenarios or converging Super Trends will affect your investments, financial plans, career or business, or how to create better transferable value in your business?**

- **Need referrals to preferred providers in our network who help with growing a business, building a stronger business or exiting/transitioning your business?**

Your SFG lead advisor or Financial Planning team members can connect you with the appropriate SFG resources.

RE-WRITING MONEY SCRIPTS

Pam recently led a Money Scripts workshop for SFG clients and friends. Money Scripts are things we learned about money as we were growing up. They include whether our parents were savers or spenders, but go well beyond that. If one parent used money to express love in the family, that "script" was often recorded in a child's subconscious. It's almost like dozens of little software programs running in our subconscious – some are good programs, like being frugal, while others can be very destructive, like using money as a weapon during disagreements or trying to control someone.

Some scripts can be both good and bad. One of our clients had worked hard when he was young to earn his own money to buy a bike. It was a great sense of accomplishment. He succeeded in earning huge sums of money later in life. But the script resulted in a workaholic lifestyle that ruined his marriage, his relationship with his children and his health.

Here are some ways to re-write Money Scripts:

- **Discovering and accepting your own Money Scripts** – the first step to wellness – it sounds easy but getting over deeply held patterns of behavior is often challenging.

- **Looking at the shadows** – are you willing to confront negative scripts that may be causing destructive behavior with money or in your life? Most of us don't like examining the darker side of our nature.

- **Wanting and deciding to change** – unfortunately, many people only decide to confront their destructive habits when faced with a crisis. Three factors often accompany the true life changing, re-writing of Money Scripts: 1) hitting bottom, 2) enough knowledge to realize other choices are available and/or 3) hope for something better on the other side of the pain.

- **Dealing with difficult emotions** – nothing else is more authentically you than your feelings. A common way we keep ourselves stuck in the cycle of financial (and other) scripts is by using either behavioral or chemical medicators. These can range from food addictions to substance abuse to compulsive spending, even sex addiction.

- **Consciously making good decisions** – this can include writing new, more positive scripts, journaling, meditation or therapy (light or heavy). Some people can re-write later chapters of their life with the help of friends and family.

WANT TO LEARN MORE? Read Rick Kahler's book, ***Unconscious Finance***. Pam and other SFG team members are available to present this topic to small or large groups or lead local workshops on Money Scripts. Contact Libby Stafford at lstafford@StearnsFinancial.com or 800-881-7374 for more information.