

▶ Market Overview 3Q 2016

The Yogi Berra Market

"It's tough to make predictions, especially about the future." - Yogi Berra

MARKET REVIEW

Global Equity Markets

Global equities extended their post-Brexit rally in Q3, uplifted by central bank support, most visibly in the form of aggressive quantitative easing from the Bank of Japan (BOJ) and European Central Bank (ECB) along with the U.S. Federal Reserve's refusal to raise the federal funds rate at both its July and September meetings. Stocks also got a bid from signs of improvement in the U.S. economy, which appeared to strengthen from its slow pace in the year's first half. The MSCI EAFE all-developed market index returned 6.1% in terms of local currencies. European markets were buoyant; in local currencies Germany gained 8.8%, France 5.2%, the U.K. rose 7.0% and Spain gained 8.2%. Italy lagged due to concerns over its banking sector, but still returned a positive 1.2%. In the U.S., the S&P 500 returned 3.8% while the small-cap Russell 2000 jumped just over 9%. Japan gained 7.3% in yen terms. Emerging markets also posted strong gains as the MSCI Emerging Markets Index returned 7.7% in local currencies; Hong Kong, South Korea and Taiwan all gained over 10% for U.S. dollar-based investors, while most other country constituents also showed positive results. The U.S. dollar drifted sideways against a broad trade-weighted group of currencies during the quarter after rising 20% from early 2013 through early 2016, and ended the quarter little changed overall.

Information technology led sector returns in the U.S. and globally, gaining about 15% in the MSCI All-Country World (ACWI) ex-U.S. Index and 13% in the S&P 500 (in U.S. dollars); improving U.S. economic prospects and improving earnings outlooks were cited as reasons for the strength. Defensive sectors lagged after strong gains earlier in the year. Utilities and telecom services each gave up about 6% in the S&P 500 while healthcare gained only 1%. Utilities, telecom services and healthcare also lagged globally; in the MSCI ACWI ex-U.S. Index healthcare lost about 2% while the other two sectors were flat.

Trailing 12-month results show little evidence of January's nervous market dive when global recession fears dominated sentiment or late June's brief Brexit-inspired weakness. The S&P 500 returned 15.3% with broad based strength across most sectors.



Summary

- Global equities extended their post-Brexit rally in Q3, uplifted by central bank support and prospects for stronger U.S. growth. Trailing 12-month returns show little evidence of January's weakness or the brief post-Brexit decline; global equities gained over 7% while the S&P 500 rose 15%.
- Bond returns were about flat for the quarter in the U.S. and globally. Credit spreads tightened slightly, remaining well-below early 2016 levels. Falling government yields and narrowing spreads produced strong returns for the trailing 12 months.
- Aggressive central bank stimulus has supported risk assets but has not led to strong global growth. Its effectiveness is being questioned the world over, but there is little clarity on what governments or central banks will do if growth stays weak. The potential range of market outcomes is wide and likely to be shaped by future policy choices. Investors should establish strong governance policies and address any downside volatility with disciplined rebalancing.

The Russell 1000 Value (+16.1%) and Growth (+13.6%) Indices performed comparably as did small-caps; the Russell 2000 matched the S&P 500, returning 15.3%.

Trailing 12-month international returns were more muted and diverse. The MSCI ACWI ex-U.S. Index returned 7.4% in local currencies and 9.7% in U.S. dollars as the dollar weakened slightly. Emerging markets gained about 13% in local currencies, benefitting from broad-based strength among Asian nations in the Index and a rebound on the part of Brazil after severe multi-year losses. Among developed markets, Japan (-5.2%), Italy (-21.6%) and Spain (-6.3%) all lagged while the U.K. gained about 18% (although only 2% in U.S. dollars). Germany gained just over 8% and France just over 2%, each in euros.

Long-term returns give a clearer picture of meaningful performance trends and better depict forces shaping portfolio results. U.S. equities have dominated global markets, returning about 11% and 16% compounded annually over the trailing three- and five-years at September 30 compared with only 1% and 6% for the MSCI ACWI ex-U.S. (all in U.S. dollars). This is partly due to better U.S. economic performance relative to that of Europe and Japan and to dollar strength, but ACWI ex-U.S. returns in local currencies have also lagged the U.S. Europe has struggled with very slow growth, worries over European banks and general regional disputes over policy governance of the common currency area. Emerging markets have underperformed on the impact of energy and commodity exposure and currency weakness; in U.S. dollars, the MSCI EM Index returned only -0.2% and 3.4% annually over three and five years.

Global Fixed Income Markets

Global 10-year government bond yields were little changed in Q3 after steep declines over the past two to three years. The U.S. remained the highest-yielding major global market, with the 10-year Treasury at about 1.6% at quarter end versus less-than-zero yields, at about -0.1%, in Germany and in Japan. Government yields at the five-year mark were negative across much of the Eurozone, as ECB buying continued at an 80 billion euro monthly pace and was extended during Q3 to include corporate bonds. The Swiss government yield curve was negative across its entire 30-year span as Q3 came to a close. The U.K. 10-year government yielded 0.6%.

The U.S. Treasury curve edged up slightly in the U.S. but yields remained well below year-ago levels from about the five-year point out the curve. Zero or near-zero policy rates and

aggressive asset purchase programs in Europe and Japan have driven investors in to risk assets; credit spreads in Europe and the U.S. drifted lower in Q3, remaining well-below early 2016 levels. The Bloomberg Barclays U.S. Aggregate returned 0.5% for the quarter while mortgage-backed (MBS) and asset-backed (ABS) indices returned 0.2% and 0.6%. U.S. high-yield returned a strong 5.5%. The Global Aggregate (in euros) was about flat for the quarter on a slight backup in already historically low government yields. On a duration-adjusted basis in the U.S., corporates notably outperformed other sectors, followed by commercial mortgage-backed securities (CMBS), while ABS lagged.

Falling government yields and narrowing spreads drove strong bond returns for the trailing 12 months. The Bloomberg Barclays U.S. Aggregate returned nearly 5.2%, while high-yield returned more than 13%. The Global Aggregate (in euros) returned 8.1% for the trailing year; its Treasury component returned 10% while industrials and utilities among corporates returned about 8% and finance lagged at just over 5%. Duration-adjusted excess returns in the U.S. for the year were the same as in Q3: corporates notably outperformed, followed by commercial mortgage-backed securities (CMBS), while ABS lagged.

Global Economic Review

The U.S. economy continued to remain an island of relative strength among developed market regions and growth estimates for the second half of the year strengthened slightly over the summer. GDP growth of only 0.8% in Q1 and 1.4% in Q2 appears set to improve to 2.8% in Q3 and 2.3% in Q4, according to early October consensus estimates. The Fed noted that job gains have been “solid” and “household spending is growing strongly” at its late September meeting, but that “business fixed investment has remained soft.” And the U.S. outlook is far from strong by historical standards, with calendar year 2017 and 2018 consensus growth estimates now pegged at just over 2.0%.

Eurozone growth is weaker and has faded this year rather than strengthened, with 2016 full year growth estimated at 1.5%, down from 2015's 1.9%, while 2017 growth is forecast to slip further to 1.4%. Growth is also fading in the United Kingdom, partly a result of the Brexit vote; the consensus outlook for 2016 GDP is about 1.7%, down from 2.2% in 2015 and 3.1% in 2014. For 2017, U.K. growth is expected for slow to 0.8%. There was little change in prospects for Japan's glacially slow pace of growth — where expectations remained mired in a range of 0.6% to 0.7% through 2018.

Asia remains the strongest global region, despite China's slowdown and the fears surrounding its load of bad debts, property bubble and potential for a banking crisis which have dogged its outlook for years — so far without much effect. While China's expected 6% growth over the next several years represents its slowest pace in decades, it's one of the world's strongest outlooks. India and the Philippines show outlooks for 7%+ expansion and several other south Asian nations appear set for 3% to 4% expansion — yet these economies aren't large enough to pull the rest of the world along.

THE YOGI BERRA MARKET

If you were gifted with clairvoyance that could see the strength of future economic growth and corporate earnings, you would likely consider that a tremendous advantage as an investor. If, in late 2013, you could see that global growth would be disappointingly sluggish, corporate earnings outlooks would be repeatedly cut and the S&P 500 would grind through a six-quarter earnings recession, you might have been tempted to confidently avoid equities or even short the market. You would have cursed your gift. The S&P 500 rose nearly 30% over the same period despite disappointing fundamentals.

If your clairvoyance included central bank policy, you might have wondered what the objective of the central banks has been. Global central bank assets have grown to nearly \$20 trillion and yields in many developed countries have been driven into negative territory. To what end?

Such a confluence of realities — years of historically unprecedented global monetary stimulus combined with chronically lethargic economies — eight years after the worst financial crisis in 80 years would have been nearly unthinkable. The inherent tension between the two might have given you pause about making any prediction at all. In the words of the great 20th century philosopher and legendary New York Yankee catcher and manager Yogi Berra, "It's tough to make predictions, especially about the future."

Predicting future moves in financial markets is always difficult. But the difficulty of making successful predictions does not negate the value of thoughtful macroeconomic analysis that shapes expectations and helps us avoid emotional reactions to unexpected market moves. When our expectations are informed and insightful, our reactions can be perhaps less emotional and more disciplined.

We are faced with an environment where monetary policy

has inflated financial assets, yet real economic growth has remained sub-par. Has monetary policy reached its limits? Have we entered a period of secular stagnation? Are there alternative policy responses? And, what are the investment implications?

An Epic Flood of Money

In CBIS' view, the current market environment is especially difficult to analyze in terms of a near- to medium-term market outlook. Eight years of continuous central bank stimulus has largely failed to produce the stronger economic growth and two percent inflation that seem to be the ubiquitous goals of central banks worldwide. Yet failure hasn't been for lack of trying. Since the 2008/2009 crisis, central banks have used three primary policy tools in their attempt to boost investor confidence, spur investment and lending, and spark economies:

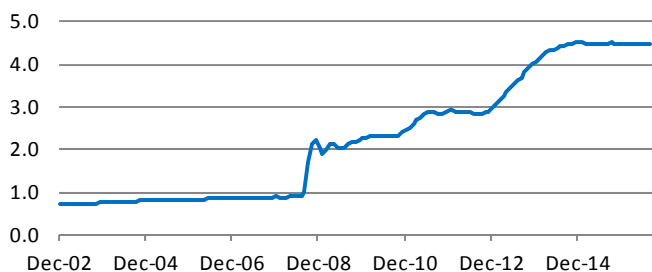
- **Quantitative Easing (QE)** — the purchase of financial assets with newly created money to suppress interest rates, promote credit extension and improve system liquidity;
- **Zero and Negative Interest Rate Policies (ZIRP and NIRP)** — setting policy rates at or below zero to force bank lending by penalizing the cost of holding reserves, and
- **Forward Guidance** — giving investors (and speculators) confidence that short-term rates will be held low for a prolonged period of time, which in turn supports credit extension at longer maturities and pulls longer-term rates down.

As shown in Tables I and II, the largest global central banks have expanded their balance sheets to a historically unprecedented degree in recent years through multiple rounds of QE. Chart II is perhaps the most illustrative, showing aggregate growth in assets from just over \$5 trillion in early 2008 to nearly \$20 trillion by August 2016. Central banks have unleashed a tidal wave of liquidity into global markets, driving rates down below zero, driving down credit spreads, pushing yield-seeking investors farther into risk assets, giving speculators confidence that central banks create a virtual floor under broad market valuations and generally making life difficult for active managers relying on traditional analysis of fundamentals and valuations.

Nor has central bank buying been limited to government bonds and mortgages. The European Central Bank (ECB) and Bank of England (BOE) initiated programs over the summer to buy corporate bonds. Both the Swiss National Bank and Bank of

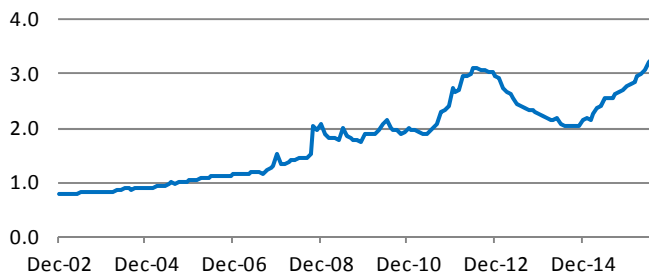
I. Growth in Central Bank Assets (through August 2016)

U.S. Federal Reserve Assets (Trillions USD)



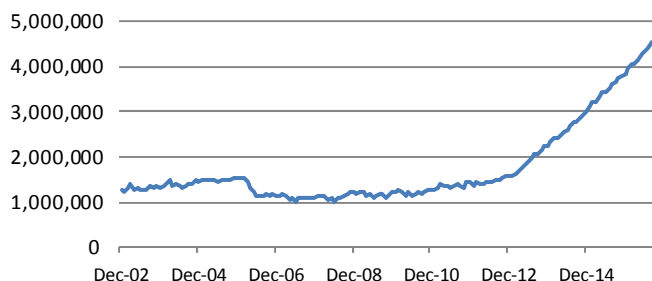
Source: Federal Reserve Bank of St. Louis (FRED)

European Central Bank Assets (Trillions EUR)



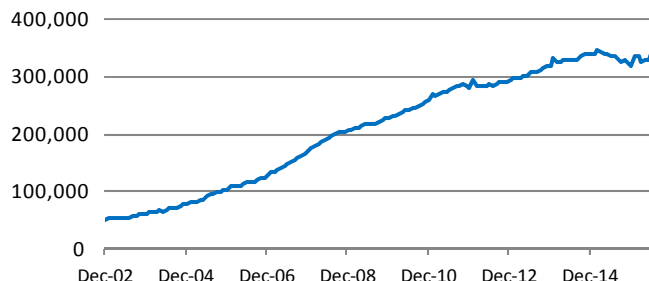
Source: Federal Reserve Bank of St. Louis (FRED)

Central Bank of Japan Assets (100 Million Yen)



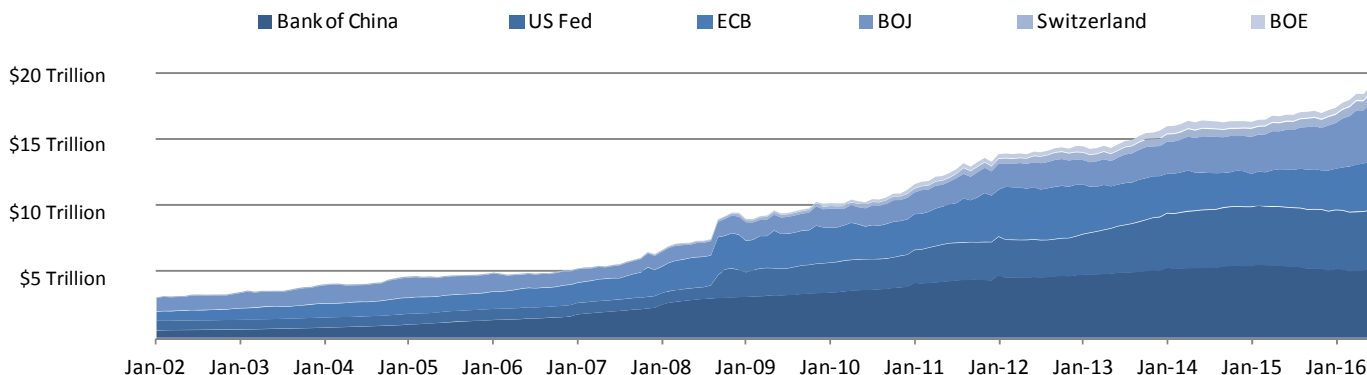
Source: Federal Reserve Bank of St. Louis (FRED)

People's Bank of China Assets (100 Million Yuan)



Source: Factset, People's Bank of China website

II. Growth in Aggregate Central Bank Assets (through August 2016)

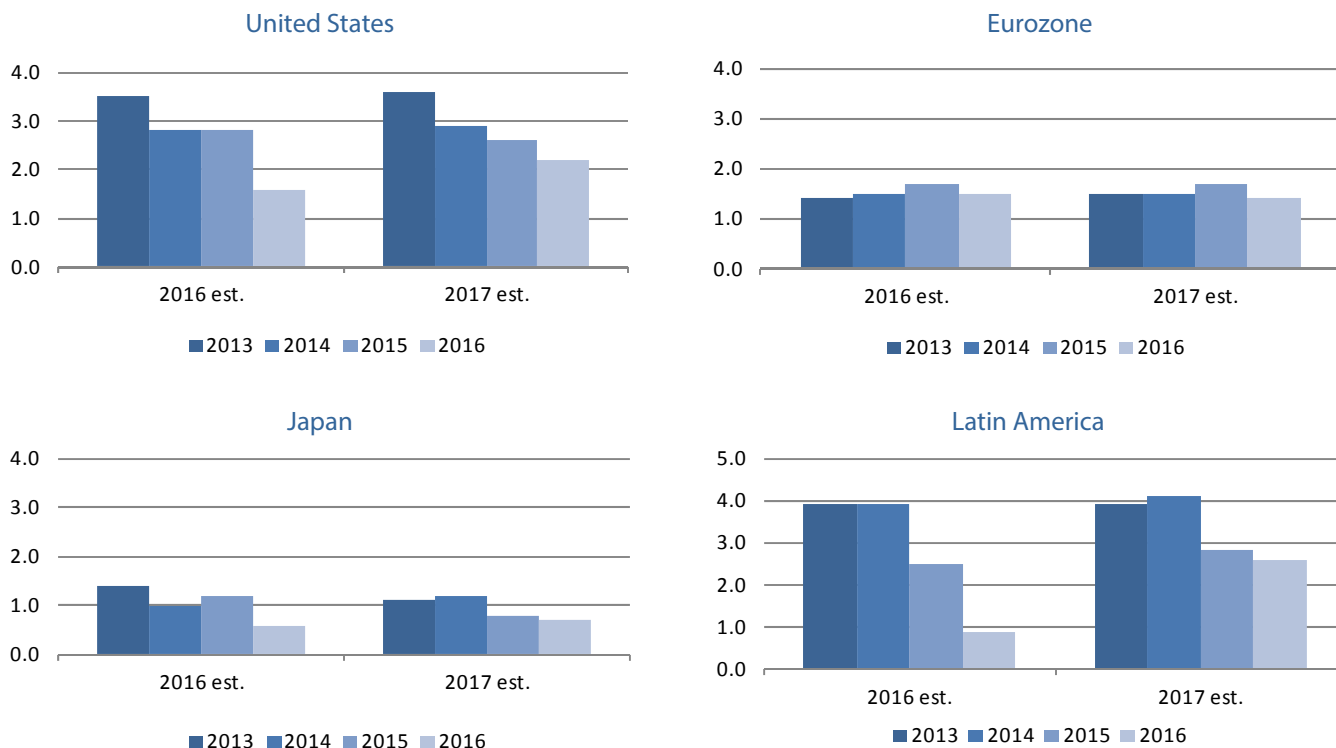


Source: Factset, U.S. Federal Reserve Bank of St. Louis (FRED) and respective central bank websites.

Japan (BOJ) are equity market investors. The Swiss National bank, according to U.S. regulatory filings, owned \$62 billion in U.S. stocks at the end of Q2, a 50% increase from the start of the year. The BOJ began buying Japanese stocks in 2010 at a pace of about 50 billion yen annually and said in July it would double its rate, now at 3.3 trillion yen per year, to 6 trillion yen (about \$65 billion), mostly through ETF purchases. A Goldman Sachs

report quoted in the *Financial Times* (FT) in August said the BOJ will own at least 10% of the equity in 32 Japanese companies within a year. The *FT* also reported the BOJ is now a larger buyer than any other investor bloc in the Japanese market. It's no wonder investors have been trained in recent years to buy market dips when central banks themselves are doing so. The old adage still holds true: "It is hard to fight the Fed."

III. Diminished Expectations: Evolution of Predicted % Real GDP Growth for 2016 & 2017



Source: Factset Economics Estimates / Latin America includes Argentina, Brazil, Chile, Colombia, Mexico, Peru

Where's the Growth?

While central banks have indeed been successful in inflating financial assets, the question remains whether this policy has been effective in supporting real economic growth. The failure of optimistic economic and corporate earnings forecasts to materialize in recent years has become almost a cliché. The ritual is the same as each year unfolds: optimism fades in the face of weak data, growth estimates come down, markets falter and central banks come to the rescue with more aggressive and ambitious policy responses. Chart III illustrates the theme. The chart shows the evolution of estimated calendar 2016 and 2017 real GDP growth from September 2013 annually through September 2016. Only the Eurozone showed stability, but from a base so low the word “growth” hardly applies. And there too a hint of strength in 2015 melted in the face of weak data and June’s Brexit vote.

The counterpart to faltering economic growth estimates has been a similar reduction in corporate earnings outlooks, a theme we have discussed in recent quarterly letters. Chart IV, which illustrates the general trend in the U.S., shows the evolution of estimated calendar year 2016 S&P 500 aggregate earnings

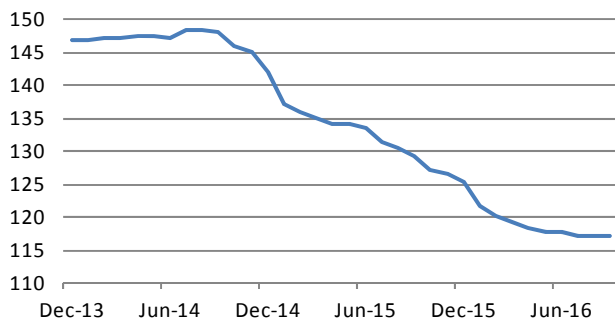
per share since late 2013. The energy sector’s earnings recession after 2014’s oil price collapse is a contributor to the decline, but the overall pattern depicts a broader reality. Earnings data compiled by Zacks (www.Zacks.com) present a similar picture. Zacks measures aggregate earnings, thereby avoiding the boost share buybacks give earnings per share, and notes Q3 2016 is set to be a sixth straight quarter of declining year-to-year net income for S&P 500 companies as a group. Removing the weak energy sector improves Zacks’ numbers somewhat, but only to about zero “growth” in each of the most recent four quarters.

Despite recent results, expectations continue to be robust. Zacks’ survey of analyst estimates shows a 5% jump in expected S&P 500 earnings for Q4 2016 and 10%+ growth in calendar years 2017 and 2018, with strength evident from both a rebounding energy sector and broadly across sectors.

Bursting the Confidence Bubble

Whether today’s optimism will prove as illusory as that of recent years is a prediction that’s hard to make with any confidence. What isn’t hard to predict is an erosion in the confidence of central banks to create growth through asset purchases. So far this

IV. Evolution of Estimated 2016 S&P 500 EPS (\$/Share)



Source: Factset

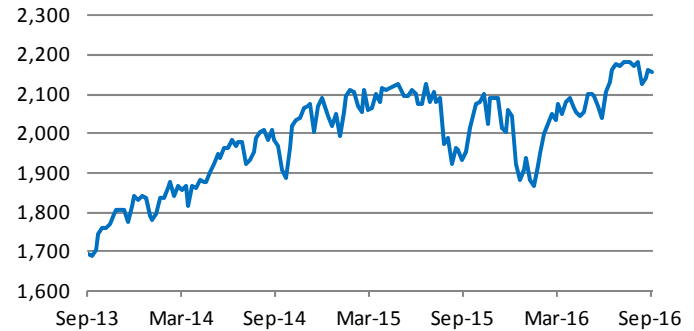
year, several of the world's largest and most powerful economic institutions have issued reports that offer critical assessments of global economic performance and governance.

■ [The International Monetary Fund \(IMF\)](#) gave its 2016 World Economic Outlook, released in April 2016, the title “Too Slow for Too Long” and said the world faced risk of an “economic derailment” while calling for coordinated government stimulus to counter what it describes as a weak and fragile global economy and rising income inequality. And it called on governments to foster a more inclusive prosperity.

■ [The World Bank](#) in its June 2016 Global Economic Prospects report cut its 2016 global growth forecast to 2.4% from its January estimate of 2.9% and warned that “in an environment of anemic growth, the global economy faces pronounced risks, including a further slowdown in major emerging markets, sharp changes in financial market sentiment . . . and concerns about the effectiveness of monetary policy. . . .” The report urged governments to invest in infrastructure, education, health, human skills and wellbeing and institute policies to improve standards of living.

■ [The Organization for Economic Cooperation and Development \(OECD\)](#) in its Interim Economic Outlook, released in September 2016, noted that global monetary policy has “become overburdened and is creating distortions in financial markets.” It called for more and collective fiscal policy along with structural reforms to boost growth and promote what it termed “inclusiveness.” William White, chairman of OECD's economic committee (and former Bank for International Settlements research economist who was one of the few mainstream central bankers to predict the 2008/2009 crisis) was more blunt in a September 25, 2017 editorial published in the *FT*. Unprecedented monetary experimentation over the past eight years, he

V. S&P 500 Index Price



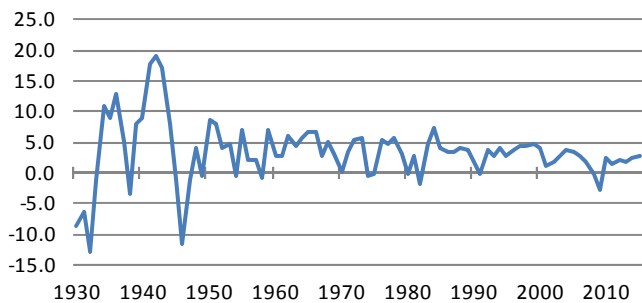
Source: Yahoo Finance / Note: September 2013 through September 2016

noted, has failed to stimulate demand, fostered financial instability, created mountains of unproductive debt, resulted in capital misallocation and that government action will be required to solve the problems monetary policy has created. He called for a “paradigm shift in thinking about how the economy and policy work” and said the way forward “relies on government action rather than that of central banks.”

■ By far the most severe critique was issued by the [United Nations Conference on Trade and Development](#) who, in a report issued in September 2016, said, “The world economy in 2016 is in a fragile state, with growth likely to dip below the 2.5 per cent registered in 2014 and 2015.” The report offered a savage review of financial globalization, indicting central bank easy money policies for fomenting an emerging market debt bubble and citing corporations’ failure to reinvest profits, focusing instead on short-term share boosting schemes, as a cause of falling global productivity. The report said lack of corporate investment is a primary engine of inequality and weakening aggregate demand, and called economic growth strategies based on wage suppression and fiscal austerity policies a demand destroyer. It said a global new deal may be required to address global imbalances and avert the possibility of epic debt defaults.

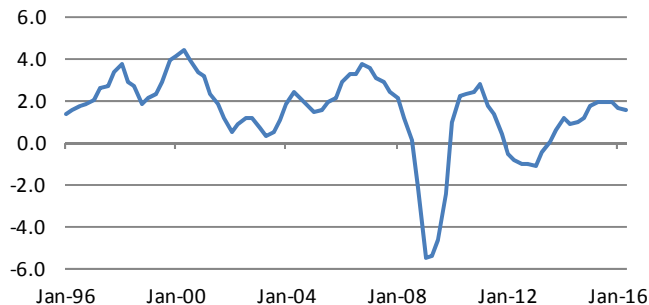
Economics isn't called “political economy” (or “the dismal science”) for nothing; 2% to 3% growth is far from a depression and hyperbole gains attention. Yet these reports are emblematic of shifting global political winds. Citizens in developed nations are tired, frustrated and increasingly disenchanted with zero yields on their savings, with central bank policies that only inflate asset prices and widen wealth inequality and with economies that don't work as well and as inclusively as they should. Charts VI and VII illustrate this theme as it applies in the U.S.

VI. U.S. Real GDP (% Growth vs. Year Ago)



Source: Reserve Bank of St. Louis (FRED) / Note: Calendar year data through 2015

VII. Eurozone Real GDP (% Growth vs. Year Ago)



Source: Reserve Bank of St. Louis (FRED) / Note: Quarterly data through Q2 2016

and in Europe. While almost dwarfed by the scale of time, the line in the U.S. since about 2000 is telling. The post-World War II pattern of strong recoveries from short recessions has been shattered; growth hasn't been anywhere near 5% since the 20th century.

Central banks are taking notice too, but their remedies may only be more of the same. Larry Summers, Treasury Secretary during the Clinton administration, former economic adviser to President Obama and bellwether for the mind-set of serious economists worldwide, at a Bank of Japan conference in late September suggested global central banks should consider GDP targeting and the purchase of a "wider range of assets on a sustained and continuous basis" to combat "secular stagnation" (his term for the failure of global growth rates to reach historical norms). In late September, at a banker's conference in the U.S., Fed Chair Janet Yellen floated the idea that purchase of stocks and bonds may help the Fed better respond to future economic weakness and that targeting nominal GDP is another policy tool that merits study. Trial balloons for additional forms of ECB stimulus regularly appear in the financial press too.

We are concerned central banks cannot solve the growth problem by themselves. Higher asset prices are not translating into higher economic growth rates. Fiscal policy must become a part of the solution.

Investment Implications

What does this all mean for the management of participant portfolios? The potential range of market outcomes is very wide indeed and likely to be shaped by policy choices that have yet to be made.

An optimistic future would mirror the current consensus outlook among Wall Street analysts: the natural proclivity of economies to grow finally asserts itself, U.S. and global growth

strengthens, corporate profits rebound, the Fed's slow tightening resumes, rising profits support equities in the U.S. and globally, bond yields rise gradually, and financial market returns approximate the mid single-digit forecasts embodied in long-term asset allocation modeling.

Pessimistic path analysis involves more drama and creativity, but without loss of plausibility. One potential future would see U.S. and global growth and earnings continue to disappoint, possibly rattling political nerves and forcing some sort of now-uncertain fiscal policy response. The long-standing divergence between equity prices and earnings fundamentals may yet be resolved in favor of fundamentals. An equity bear market could be the outcome, along with a sharp rise in credit spreads, although safe-haven government yields may fall even further.

On the other hand, if economies and earnings continue to languish, central bank firepower may be redoubled again, with the Fed joining the ECB and BOJ in potentially more creative stimulus. There is no guarantee political discord could constrain such a scenario, particularly if gridlock and indecision surrounding fiscal policy assure that central banks remain the only actors capable of "doing something".

There is little historical precedent other than the past few years for analyzing stock valuations in a backdrop of massive coordinated global QE and prolonged negative interest rates. Perhaps it's best not to try, yet a "melt up" in equity valuations, building on the foundation produced by central bank easing so far, cannot be ruled out.

Two sigma events (i.e. two standard deviations away from the average) occur with regularity — about 1 in 20 times based on the normal probability distribution. Given the myriad of economic, monetary and fiscal policy uncertainties facing markets today, an investor using a long-term capital market assumption that contemplates annual 17% to 18% equity volatility (i.e. one

standard deviation) should not be shocked by a 35% to 40% decline in stock prices (roughly a two sigma event) or a surge for that matter if central banks expand toolkits to include stocks, bonds, GDP and anything they believe can boost growth and price levels. Almost any market scenario seems plausible.

Buying low and selling high is easy to imagine but very, very hard to do. Yogi Berra observed, “You’ve got to be very careful if you don’t know where you are going, because you might not get there.” If investment success is the destination, getting there requires a reasonably informed understanding of market risks and

opportunities. You avoid being blindsided and shaken by a ride that turns rough and you’re better prepared to deal with it if it does. The best plan is to understand the range of possible outcomes while not trying to predict them with any precision, make sure budgets and spending plans can withstand the stress of downside volatility, and institute a strong governance structure that specifies target asset class weights and a disciplined rebalancing strategy. You can’t predict the future, but when it comes you won’t be completely surprised. And that will be a real advantage for you as an investor. ■

Important Information

This is for informational purposes only and does not constitute an offer to sell any investment. The funds are not available for sale in all jurisdictions. Where available for sale, an offer will only be made through the prospectus for the funds, and the funds may only be sold in compliance with all applicable country and local laws and regulations.