CBIS

1Q 2016

Market Overview

UNINTENDED CONSEQUENCES

If an object lesson were ever needed in the futility of fervidly overanalyzing the market's every twist, turn, jump and dive, the first quarter of 2016 could hardly be surpassed. It was a wild ride, and for all its drama it went almost nowhere. The year began with renewed fears of deepening global economic malaise, visibly marked by a drop in oil prices from $35/barrel to $25/barrel by mid-February. Investors faced what looked like a perfectly bearish storm:

- A relentlessly weak Eurozone economy
- Heavily indebted emerging market economies burdened by depressed commodity prices and a strengthening U.S. dollar
- Broad concerns over China's economic slowdown
- The prospect of four U.S. Federal Reserve rate hikes in the year ahead

Stocks fell and credit spreads surged as "risk off" sentiment dominated global markets. By early February, U.S. equities were off 10% in one of the worst starts to a year in history, while other broad-based measures of global equities fell into bear market territory (a decline of 20% from the highs) for the first time since 2011.

And then something changed.

What that was is hard to pinpoint in time, but not in kind. Dovish talk and then dovish action by the enormously powerful cabal of global central banks came once again to the rescue of faltering markets, as it has so many times since the financial crisis of 2008-2009. It began in January with the Bank of Japan's introduction for the first time of a negative policy rate to jolt its economy away from deflation. In February

Catholic Responsible Investing

Market Summary

- An early sell-off, with U.S. equities down 10% and other broad measures of global equities falling into bear market territory.
- Dovish moves by global central banks came once again to the rescue of faltering markets, and fortunes reversed by quarter-end.
- The U.S. dollar rally stalled and the U.S. currency generally weakened.
- The prevalence of negative yields in Europe and Japan shaped fixed-income market returns in Q1, while U.S. bonds showed generally strong returns.
- The Fed cited slow global growth as a factor in reducing its 2016 U.S. economic outlook, the ECB lowered its outlook for Eurozone growth and the outlook for Japan was weakest of all.
- Velocity declined during the financial crisis, but has continued to fall despite modest economic growth.
- An increase in excess reserves in the banking system has occurred, but the growth of deposits has not been accompanied by an increase in loans.
- Regulation may have had the unintended consequence of restricting capital.

the People's Bank of China reduced reserve requirements and, with the full authority of China's command economy, encouraged more lending. In February, markets were soothed by hints that the European Central Bank (ECB) and U.S. Federal Reserve were prepared to use policy tools to counter a faltering economic outlook and weak financial markets. In March, the ECB unveiled a raft of new measures to again stimulate Eurozone growth, including a 20 billion euro increase in monthly bond purchases under its quantitative easing program, an expansion of the program to include highly rated corporate bonds and a series of loan incentives to foster bank lending to Eurozone businesses. The Fed blinked too. At its March meeting it said its planned four rate hikes in 2016 were officially off the table and that only two were now likely, citing concern over financial market volatility and a more pessimistic view of U.S. and global economic prospects.

Beginning in mid-February, markets began to register these moves. The U.S. dollar rally stalled and the U.S. currency generally weakened as the quarter continued. Oil prices firmed, helped by rumors of planned production cuts, and then rose sharply to near $40 by quarter end. Credit spreads narrowed forcefully from February highs. U.S. equity markets rallied as sharply as they had fallen. By quarter-end, anyone who had been away for three months could be forgiven for thinking that little of note had actually happened. In a real sense, they would have been right.

Global equity markets were slightly weaker than the more buoyant U.S. market for the quarter. In local currency terms, the all-developed market MSCI EAFE Index returned -6.4%, while a weaker dollar led to a better -2.9% return for U.S. dollar-based investors. The S&P 500 managed a +1.3% advance. Emerging markets performance was mixed and varied greatly depending on local economic and political conditions, but overall the MSCI Emerging Markets Index outperformed developed markets, gaining +2.8% in terms of local currencies and +5.7% in U.S. dollar terms. Developed European market equities showed pockets of weakness; in euro terms Germany fell about -7.0%, France -4.5% and Italy a notable -15.8% on fears over its banking sector's solvency. Japan declined -12.5% in yen but only -6.4% in U.S. dollar terms as the yen strengthened despite the BOJ's actions. In terms of sector performance, financials were weak both in the U.S and globally on fears of the impact of low to negative global yields on bank loan margins and, in some cases, potential exposure to energy sector debt impaired by the global collapse in oil prices since 2014. Healthcare was also weak, due in part to continued fallout from public disaffection over high drug prices, which has become an issue in the U.S. presidential election campaign. Utilities and telecom were by far the strongest U.S. sectors given the fall in yields during the quarter. Energy and consumer staples were moderately strong both in the U.S. and globally, with low- to mid-single digit gains.

The prevalence of negative yields in Europe and Japan shaped fixed-income market returns in Q1. German bund yields fell further into negative territory, out to the seven-year maturity. And in late March, Bloomberg reported that nearly $8 trillion of bonds globally now have negative yields, forcing many global bond investors into positive-yielding U.S. markets. Along with a dovish Fed, this drove U.S. rates down in Q1. U.S. Treasury yields declined 40 to 55 basis points along the curve from the three-year to the 30-year maturity. U.S. credit spreads spiked sharply higher through early February along with the decline in equity markets, but recovered, and ended the period little changed. For the quarter, U.S. bonds showed generally strong returns. The Barclays U.S. Aggregate Index returned +3.0%, while long Treasuries posted the highest returns, at +8.5% for the Barclays U.S. Aggregate Government 20+ year Index. Other than the mortgage-backed sector, which underperformed Treasuries due to the increased market volatility, all other fixed income sectors outperformed Treasuries on a duration-adjusted basis.

ECONOMIC OVERVIEW

The Fed cited slow global growth and potentially weaker U.S. exports as a factor in reducing its 2016 U.S. economic outlook in March to real growth of 2.2% from 2.4% early in the year. The ECB lowered its outlook for Eurozone growth from 1.7% to 1.4% in March and reduced its inflation outlook to just 0.1% from 1.0% as the year began. The outlook for Japan was weakest of all. Japan's economy contracted by 1.4% in the final quarter of 2015 and in early April economists expected only

0.7% GDP growth in 2016, 0.2 percentage points lower than a month before. For 2017, the growth outlook for Japan is only 0.6%. China's prospect for 6.5% real growth in 2016 seems super-charged by comparison, but represents the nation's slowest growth rate in twenty-five years. In early April, the International Monetary Fund (IMF) again cut its global growth forecast to 3.2% in 2016, down by 0.2 percentage point from its January projection; the IMF said China's slowdown and weak commodity prices were weighing on emerging market economies more than it had expected, while developed market nations were still struggling to escape the legacies of the 2008/2009 financial crisis.

With such a broad-based backdrop of economic malaise, the market rally during the second half of the quarter had no counterpart in stronger corporate earnings estimates. In fact, earnings estimates generally declined as the quarter unfolded. In early April, Zacks.com (which tracks analysts' earnings forecasts) projected a -10.9% decline for Q1 2016 S&P 500 earnings on 2.2% lower revenue; this is down from a projected -1% decline at the beginning of the year. The weakness was broad based, effecting 14 of the 16 economic sectors Zacks monitors. Earnings are set to decline again in Q2, based on Zacks' estimates, down -5.5%. Year-to-year gains begin in Q3 with a projected +8.1% increase, with Q4 showing a more optimistic +11.8% gain. Part of the second half strength is due to better year-to-year comparisons for energy, but that only illuminates the broader challenge facing corporate America in its search for the earnings growth that underpins stock prices. Projections for calendar year 2017 earnings growth for the S&P 500 remains an optimistic +13.6%, based on Factset data, but that would seem to require a much stronger economic growth backdrop than is evident right now in most global regions. If central bank policy is going to ever translate into real economic strength, the results cannot be postponed forever. In the long run, stock prices are based on earnings. Earnings growth, far more than central bank policy, will eventually be needed to power further market gains.

UNINTENDED CONSEQUENCES

Global central banks have cut policy rates 637 times and spent $12.3 trillion on asset purchases since the Great Financial Crisis (GFC) of 2008, according to a Bloomberg news story published in late March *("Helicopter Money Takes Flight as Latest Drastic Monetary Idea").* And yet they stand prepared to do even more, based on public statements by Fed, BOJ and ECB officials during Q1, to stimulate growth, ward off deflation and prop up markets. U.S. Federal Reserve Chairman Janet Yellen was asked during Congressional testimony whether the Fed would consider a move to a negative interest rate policy (NIRP) and she notably refused to rule it out. While the European experiment with NIRP has, so far, produced few unexpected ill effects, the announcement of NIRP in Japan was accompanied by increased market volatility and an unforeseen strengthening of the Japanese yen.

Averages can be deceiving. In recent quarterly letters we have discussed the divergences in the equity markets: growth versus value, large-cap versus small-cap, FANG (Facebook, Alphabet, Netfix, Google) versus everyone else. Divergences are not exclusive to the equity markets. The broad stock market, as measured by the Wilshire 5000, has risen approximately 20% per year since the market bottom in 2009 and unemployment has declined to approximately 5% from an October 2009 peak of 10%, yet average real income in the U.S. is flat over the period and the labor participation rate has declined to levels not seen since the late 1970s. A potentially more analytically illuminating divergence is highlighted in a Goldman Sachs study *("The Two-Speed Economy")* published in April 2015. The study found that:

- Large firms, those with annual revenue in excess of $50 million, experienced revenue growth of 8% on a compound annual basis between 2009 and 2011.
- Smaller firms, those with annual revenue less than $10 million, experienced revenue growth of only 2% over the same timeframe.

- The cumulative change in employment at firms with fewer than 500 employees historically outpaced the comparable figure for large firms. This trend has reversed since 2008, with the rise in employment at smaller firms running significantly below that of larger firms.
- Wage growth lags at small firms versus larger firms.

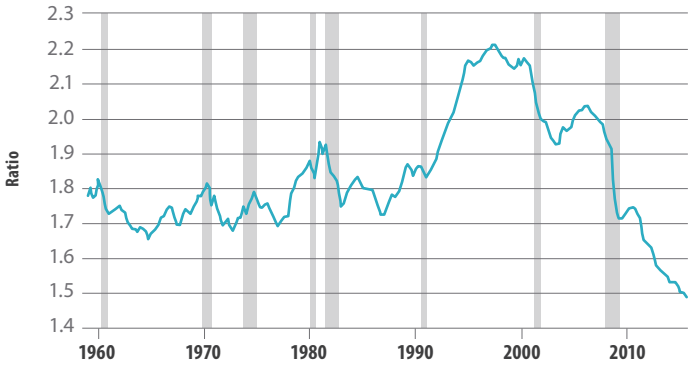
The study also highlights the fact that the number of small firms declined over the five years that followed the GFC – the first such occurrence since the data became available in 1977. Given the role small business creation has played historically in supporting U.S. economic growth these statistics provide a potential explanation for why the strength of the current economic recovery has lagged that of past recoveries. And it begs the question: why has the environment been so difficult for small firms?

One answer may be found in the changing U.S. banking environment. Small- and medium-sized businesses are more dependent on bank lending than are larger counterparts. Large firms have access to other sources of credit through the capital markets. The well-intentioned introduction of the Dodd Frank Act (DFA), which became law in 2010, may have had the unfortunate unintended consequence of restricting the primary source of capital needed to fuel small business growth. Consider a quote from Fed Governor Elizabeth Duke's testimony to Congress in February 2010, "Some banks may be overly conservative in their small business lending because of concerns that they will be subject to criticism from their examiners…some potential profitable loans to creditworthy small businesses may have been lost because of these concerns, *particularly on the part of small banks.*" (Emphasis added) Furthermore, a Federal Reserve Bank of Richmond report in March 2015 notes that "The rate of new bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010." The report also points out that new bank formation is more likely when there are fewer regulatory restrictions. Such regulations, as were passed in DFA, may be particularly burdensome for small banks that are just getting started. Finally, a working paper published by the Harvard Kennedy School in 2015 states "Community bank's share of U.S. banking assets and lending markets has fallen from over 40 percent in 1994 to around 20 percent today. Interestingly, we find that that community banks emerged from the financial crisis with a market share 6 percent lower, but since the second quarter of 2010 – around the time of the passage of the Dodd-Frank Act – their share of commercial banking assets has declined at a rate almost double that between the second quarter of 2006 and 2010." In an effort to protect the financial system, new regulation may have had the unintended consequence of restricting capital to fuel economic growth.

The other potential unintended consequence we are monitoring is the impact of unique monetary policies. It will probably take years to determine the true impact of the grand experiment in central banking known as quantitative easing (QE) and the true efficacy of post-financial crisis monetary policy. We know we have so far avoided a second Great Depression. The U.S. economy is growing (albeit at a slow pace by historical standards) and unemployment has declined to about 5%. From the Fed's perspective, it could have been a lot worse. However, we don't know what the long-term implications will be. Increasingly linked global economies and capital markets mean that many variables and interrelationships shape the financial impact of central bank policy. And given the Fed's inclination to be more rather than less transparent, the markets have been filled with numerous "crowded trades" which can temporarily cloud the true market-based effects of policy actions. While it is too early to conclusively judge the impact of QE in the U.S., it is not too early to observe that the power of similar monetary tools used in Europe and Japan seems to be diminishing and that monetary policy alone cannot change an economy's structural dynamics. For example, Japan's experience has shown it is very difficult to generate inflation in an ageing population. Maybe immigration isn't such a bad thing after all. While it is too early to declare U.S. monetary policy a success or failure, there are a few things that bear watching as the Fed embarks on its journey to normalize monetary policy.

There is an idea in economics called "the quantity theory of money." It states that nominal GDP growth equals the amount of money in the economy multiplied by the number of times the money is used. The number of times money is used during a given period is called "velocity." The early monetarist economists assumed velocity was constant in the short run, therefore nominal economic activity was directly related to the growth in the money supply. They also believed the economy naturally grew close to potential, hence money growth in excess of the growth in potential GDP led to price increases. The variability of velocity in the 1980s and 1990s called into question the ability of the quantity theory to explain inflation, however velocity is still quite useful as a gauge for the demand for money. What does velocity tell us now?

VELOCITY OF M2 MONEY STOCK

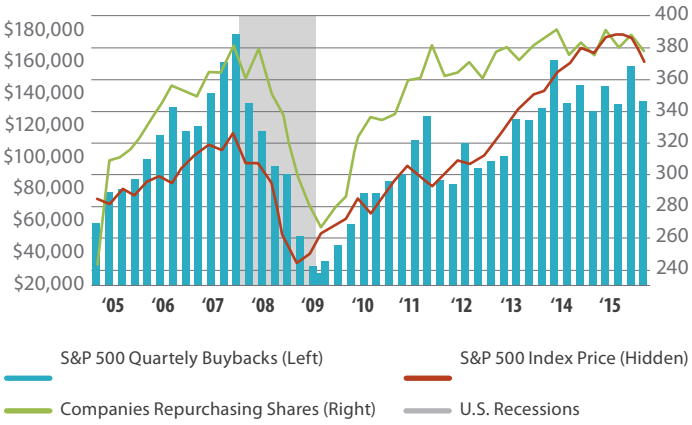


Source: Federal Reserve Bank of St. Louis (FRED), research.stlouisfed.org

Velocity declined during the financial crisis as one would expect, but it has subsequently continued to fall despite modest and steady economic growth. Increases in the money supply have simply been offset by an increase in money demand and a decrease in velocity. Are we experiencing the Keynesian liquidity trap? Is the amount of Fed bond purchases from non-bank participants simply being offset by a rise in banking reserves without an increase in lending activity?

Certainly, money demand would increase as participants hoard cash as a result of unfavorable economic expectations. This is a plausible explanation for the decline in money velocity post GFC. An article published by the Federal Reserve Bank of St Louis lays out an explanation for the continued decline in velocity: the success of the Fed. As the Fed has been successful in driving interest rates toward zero, there is very little incentive to hold interest bearing assets such as Treasury bills and certificates of deposit (CDs) as opposed to non-interest bearing forms of money. From this perspective, the decline in velocity is a measure of the Fed's success. A more cynical perspective would hold that the more artificial the level of interest rates, the more cautious decision makers become, the slower economic activity and therefore the lower money velocity. Artificially low rates will then prompt games such as stock buybacks, mergers and acquisitions, but these are essentially accounting maneuvers yielding little new productivity and are of value only to shareholders.

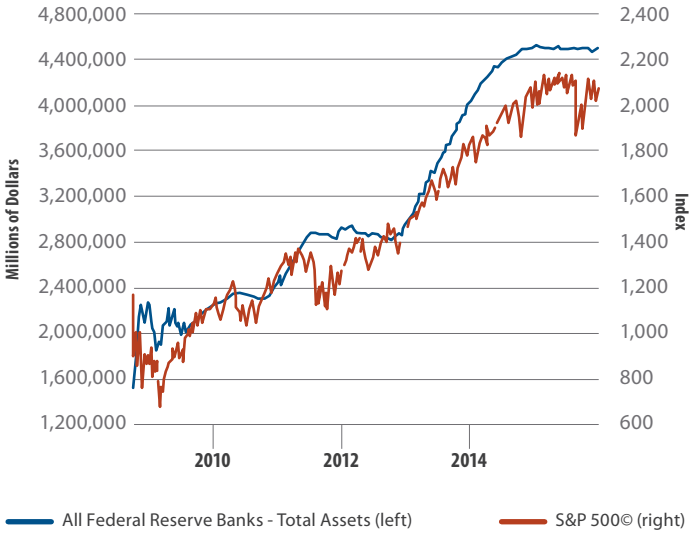
QUARTERLY SHARE REPURCHASES ($M) AND NUMBER OF COMPANIES REPURCHASING SHARES



Source: FactSet

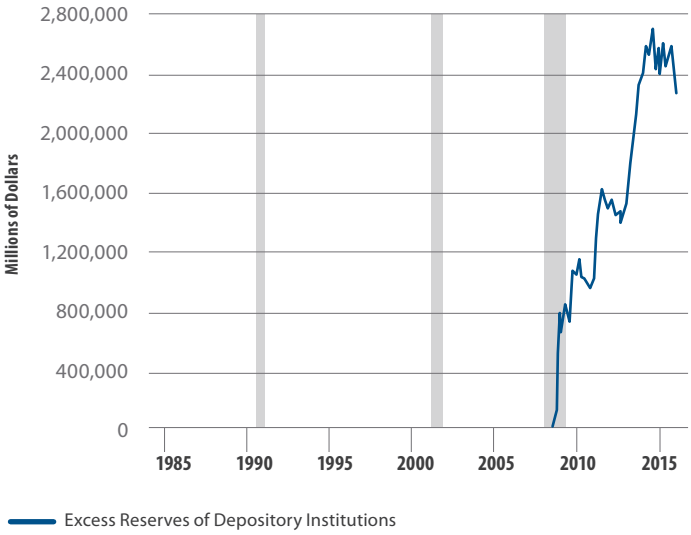
We have also seen an increase in excess reserves in the banking system. The growth of deposits in banks has not been accompanied by an increase in loans. Rather, banks are simply holding excess reserves. Again, this can be viewed optimistically as an indicator of the success of monetary policy managing the level of interest rates. In 2008, the Fed began paying interest on these reserves. The short-term impact of this policy is a decrease in the opportunity cost of holding reserves versus loans. Liquidity from Fed policy has been trapped away from the real economy and driven into the financial economy, as we have noted in prior quarterly letters.

QUANTITATIVE EASING SUPPORTING EQUITY MARKETS?



Source: research.stlouisfed.org

EXPLOSION OF EXCESS RESERVES: THE NEW NORMAL



Source: Federal Reserve Bank of St. Louis, research.stlouisfed.org

While some economic analysts believe the increase in reserves is a harbinger of inflation and beyond the control of the Fed, we need to recognize that the interest paid on reserves has become a new Fed policy tool. Unfortunately, we don't know how this new tool will work as the Fed raises interest rates in the future and manages the drawdown of its balance sheet. The arcane statistics of excess bank reserves and velocity may well hold the key to economic performance over the next several years.

As winter recedes into the past, the days are becoming longer, new growth is sprouting in the garden, and we are optimistic that the initial financial impacts of Fed policies and new regulation are subsiding. Monetary policy is normalizing in the U.S. and the inherent dynamism of the U.S. economy has slowly reasserted itself through innovation and slow but steady expansion. As a result, we are hopeful that lending to small- and mid-sized business will also improve and enable the U.S. economy to continue on an upward trajectory. Faith in central banks has powered the markets for the past several years, creating what is now an aging bull market. But faith in the economy's propensity to grow, helped by the willingness of small- to mid-sized banks to lend, has been dormant. If that can reawaken, economic growth, corporate earnings and equities may benefit from another and more traditional form of support.