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Catholic Responsible Investing

Market Overview 2Q 2017

Still Great Expectations

MARKET REVIEW

Global Equity Markets

Global equities in Q2 extended the rally that began early last year, gaining support from further improvement in Europe's economic outlook, European voters' rejection of nationalist candidates in several key elections, and ongoing stimulus from central banks. The MSCI EAFE developed market index gained about 3% in local currencies, emerging markets rose about 7%, the MSCI ACWI ex-U.S. Index (containing both developed and emerging markets) gained just over 3% in local currencies, while the S&P 500 also returned just over 3%. The trade-weighted U.S. dollar drifted lower during Q2 and has now fully retraced its late-2016 jump after Donald Trump's presidential election victory and dollar weakness added to international returns for U.S. investors. The MSCI ACWI ex-U.S. Index gained 6% in dollar terms, but the euro's strength eroded returns for euro-based global equity portfolios.

International sector returns were broadly positive for U.S. dollar-based investors, led by information technology's 13% gain; most other sectors posted mid-single-digit returns. Energy was the weakest global sector, returning -3%, as oil entered a bear market during the quarter. Crude oil prices fell below $45/barrel by late June from near $55 as the year began. Within the U.S. market, S&P 500 sector returns were led by healthcare's 7% advance with most sectors showing smaller but still-positive returns. Energy and telecom were the weakest sectors in the S&P 500, each returning about -7%. U.S. growth outperformed value as a result of its far higher exposure to strong information technology names and near-zero exposure to the weak energy sector, which accounts for nearly 11% of the Russell 1000 Value Index by weight.

Europe Embraces Continuity

Markets finished 2016 nervously watching voter sentiment across Europe after last year's surprise U.K. Brexit vote and U.S. presidential election outcome. Victories by nationalist and populist candidates in 2017's slate of elections could have shaken the political foun-

Summary

- Global equities extended 2016's rally through Q2 2017 with another quarter of steady gains. European election results favored continuity over populist upheavals and Europe's economic outlook seemed to steadily brighten. The consensus global growth outlook is steady and analysts are forecasting strong corporate earnings gains in 2017 and 2018.
- The U.S. Federal Reserve raised the federal funds rate in June to a range of 1% to 1.25%, it's second rate hike this year, Global government bond yields were slightly lower in Q2 as inflation readings remained weak, economic growth (while positive) remained sluggish, and falling oil prices dimmed the inflation outlook. Credit spreads in the U.S. and Europe drifted sideways and were little changed.
- Markets seem elevated and overdue for a correction, central banks are examining ways to exit from multi-year QE programs and the Fed is trying to raise rates. The gap between weak earnings and strong markets seems unlikely to persist forever. Earnings optimism needs to translate into reality to preserve market gains.

I. Equity Market Returns

	3 months	12 months
S&P 500	3.1	17.9
Russell 1000 Value	1.3	15.5
Russell 1000 Growth	4.7	20.4
Russell 2000	2.5	24.6
MSCI ACWI ex-U.S. (USD)	6.0	21.0
MSCI ACWI ex-U.S. (Local)	3.5	21.9
MSCI EM (USD)	6.4	24.2
MSCI EM (Local)	6.7	22.2

II. Fixed Income Market Returns

	3 months		12 months	
	Absolute	Duration-Adjusted	Absolute	Duration-Adjusted
ML 91-Day T-Bill	0.2		0.5	
Barclays U.S. Aggregate	1.4		-0.31	
U.S. Treasury	1.2		-2.32	
MBS	0.9	-0.0	-0.06	0.0
ABS	0.6	0.3	0.63	0.8
CMBS	1.4	0.3	0.02	1.8
Corporate	2.5	1.1	2.28	5.1
High Yield	2.2	1.5	12.70	14.1

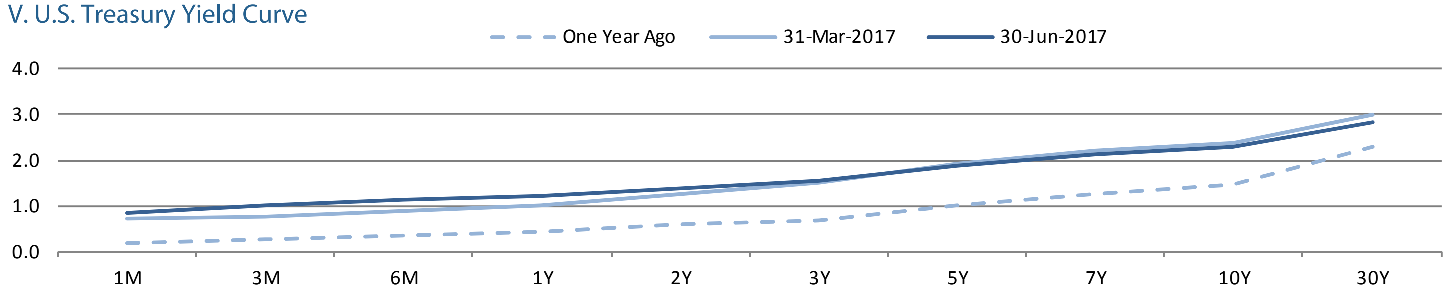
III. S&P 500 Sector Returns (USD)

	3 months	12 months
Consumer Discretionary	2.4	17.0
Consumer Staples	1.6	3.1
Energy	-6.4	-4.4
Financials	4.3	38.2
Healthcare	7.1	12.5
Industrials	4.8	22.2
Information Technology	4.2	33.9
Materials	3.2	18.9
Real Estate	2.8	-0.4
Telecom. Services	-7.0	-11.8
Utilities	2.2	3.0
Total	3.1	17.9

IV. MSCI ACWI ex-U.S. Sector Returns (USD)

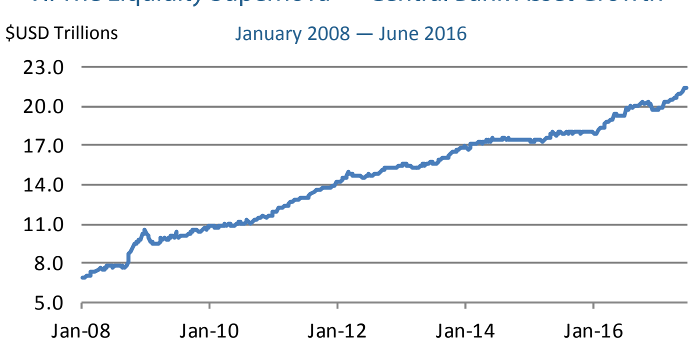
	3 months	12 months
Consumer Discretionary	5.8	24.4
Consumer Staples	7.3	6.9
Energy	-2.7	6.8
Financials	5.9	34.3
Healthcare	7.3	4.8
Industrials	7.0	24.3
Information Technology	13.0	42.3
Materials	1.9	27.2
Real Estate	5.9	9.6
Telecom. Services	4.2	3.8
Utilities	5.5	6.8
Total	6.0	21.0

V. U.S. Treasury Yield Curve



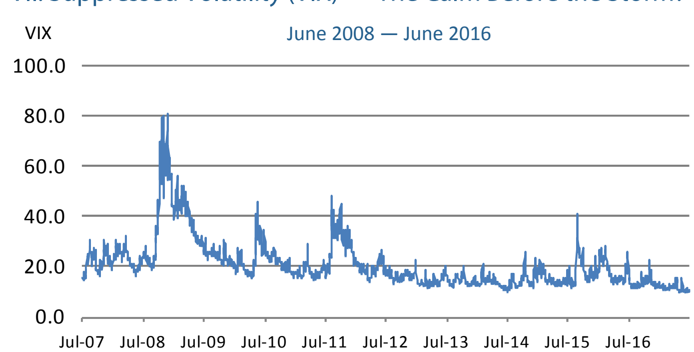
Source for Tables I-V: Factset, Bloomberg

VI. The Liquidity Supernova — Central Bank Asset Growth



Source: Factset / Global developed market central banks plus China

VII. Suppressed Volatility (VIX) — The Calm Before the Storm?



Source: St. Louis Fed (FRED), Chicago Board of Options Exchange dation of the eurozone currency bloc, potentially plunged the region back into recession, threatened a return to financial crisis given the region's unresolved debt burden, and possibly reversed Europe's multi-decade drift toward economic integration. European voters instead largely embraced the status quo, rejecting what were seen as extremist candidates in both Austria's presidential election in December 2016 and the Netherland's general election in March. But the most visible embrace of political continuity occurred in France, where former investment banker and staunch supporter of the European project Emmanuel Macron defeated nationalist and populist icon Marine Le Pen in a landslide victory. European stocks have gained about 8% overall this year in euro terms, partly due to a perceived reduction in political risk.

The Liquidity Supernova

While political winds seemed to shift, global central banks remained a bedrock of support for markets. In fact, central bank asset purchases actually increased in the first half of 2017 due to aggressive buying by the European Central Bank and Bank of Japan. Dubbed by some analysts "the liquidity supernova," aggregate central bank asset purchases year-to-date have totaled nearly $1.5 trillion dollars, the fastest pace ever. Nearly a decade on since the 2008/2009 financial crisis, central banks seem to have adopted aggressive asset purchases — including not only government bonds but mortgages and equities — as a standard policy tool. And they seem ready to use and expand QE in the face of any renewed market instability. This prospect of a global central bank "put," and the demonstrated willingness to use it, has suppressed equity volatility (measured by the VIX index) to its lowest levels since the financial crisis of 2008/2009 and has made the markets seemingly immune to any major bout of weakness.

The extension of 2016's rally through 2017's first half produced very strong returns for the trailing year. For the twelve months ended June 30, global developed markets returned 23% in local currencies while emerging markets gained about 22%. In the U.S., the S&P 500 returned 18%. Financials and information technology led returns in the U.S. and globally, while materials, industrials and consumer discretionary all produced strong gains. Energy lagged for the year given crude oil's year-to-date price slump.

Global Fixed Income Markets

Global government bond yields were slightly lower in Q2 as inflation readings remained weak, economic growth (while positive) remained sluggish, and falling oil prices dimmed the inflation outlook. Credit spreads in the U.S. and Europe drifted sideways and were little changed. The U.S. Federal Reserve raised the federal funds rate in June to a range of 1% to 1.25%, it's second rate hike this year, and said it hoped to start slowly reducing the size of its $4.5 trillion balance sheet later in 2017. The ECB likewise hinted it would like to reduce its asset purchases next year. But each institution seems reluctant to make any move that would disturb markets. Yields rose out to about the three-year maturity but fell beyond that point. The U.S. 10-year Treasury yield drifted down from 2.4% as the quarter began to 2.3% by quarter-end and the 30-year from 3.0% to 2.8%.

The Bloomberg Barclays U.S. Aggregate Bond Index returned 1.4% for the quarter while mortgage-backed (MBS) and asset-backed (ABS) indices returned 0.9% and 0.6%. U.S. high-yield returned 2.2% and investment-grade corporates returned 2.5%. On a duration-adjusted basis in the U.S., high-yield notably outperformed other sectors, followed closely by corporates, while the mortgage-backed (MBS) and agency indices lagged. The Bloomberg Barclays Global Aggregate Bond Index in euros returned -3.8%; governments returned -3.9% while corporate credit returned -2.9%, with negative returns due to euro currency strength and rising yields at short maturities.

For the trailing year, the Bloomberg Barclays U.S. Aggregate Bond Index returned -0.3% while U.S. investment-grade corporates gained 2.3%. U.S. high-yield returned 12.7% helped by strong returns from energy over the first half of the period. The Bloomberg Barclays ABS Index returned 0.6% while MBS lagged, with a -0.1% return. The Bloomberg Barclays Global Aggregate Bond Index (in euros) returned -4.7% for the trailing year; its Treasury Index component returned -7.3% while corporates returned a 0%. The euro's appreciation in 2017 weakened results, as the Bloomberg Barclays Global Aggregate Bond Index returned -2.2% in local currencies. High-yield notably led duration-adjusted excess returns in the U.S. for the year, followed by corporates. The Agency, ABS and CMBS indices performed comparably while MBS lagged.

GLOBAL ECONOMIC REVIEW

Hopes for an eventual burst of economic growth from the tax cuts, regulatory relief and infrastructure investment sought by the new Trump Administration seemed to steadily fade in the year's first half, worn down by lack of unity among Republicans and the persistent media attention surrounding the president's alleged Russia ties.

The U.S. economy posted another weak Q1 — a recurrent theme for the past several years — with real GDP growth of only 1.2%. As Q2 ended, the consensus outlook called for a rebound to 3.0% growth in Q2 and just over 2.0% in the year's second half. Markets had no expectation that Trump's agenda would boost near-term GDP since legislation needs to pass through Congress. Nevertheless, political infighting and media distractions have sapped investor confidence in the administration's ability to implement its vision. This has prevented any meaningful improvement in the longer-term growth outlook.

Confidence in prospects for the European economy, on the other hand, have steadily strengthened in 2017 and growth estimates have been revised upward. The consensus outlook for real GDP growth in the eurozone in 2017 and 2018 has risen from 1.5% each year when 2017 began to 1.8% and 1.7% respectively at the end of Q2 — not strong numbers by post-WWII historical standards, but moving in a positive direction. Combined with the year's election results, the improving outlook has inspired hopes that the continent's long and painful battle with austerity and recession may be coming to an end.

Asia (ex Japan) remains the strongest global region, despite China's slowdown and myriad of potential concerns over property bubbles and bad loans (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 (despite disruption from its move to restrict cash use) and the Philippines show consensus outlooks for 6%+ 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.

STILL GREAT EXPECTATIONS

Central bank stimulus and hopes for stronger growth and better earnings have lifted stocks since early last year. As we've noted in recent commentary, the gap between weak earnings and strong markets seems unlikely to persist forever. And the earnings outlook is indeed looking stronger, both in the U.S. and Europe, than it has for several years. S&P 500 earnings are expected to rise 11% in both 2017 and 2018. While that's a weaker 2017 outlook than what was projected last year, it's a notable strengthening from the near-zero aggregate growth in recent years. Europe's prospects are brighter still. Analysts expect corporate earnings there to jump 25% in 2017 — almost a doubling of what was forecast only a year ago — and another 10% in 2018. Falling oil prices and falling longer-term yields aren't typical coincident indicators of strengthening economies and year-to-date data here seems contrary to the brightening consensus outlook (although these are forms of stimulus that can benefit future growth). Oil price weakness may be explained by a range of factors: rising U.S. shale production, surprisingly strong production from non-OPEC producers such as Libya and Nigeria, wrangling within OPEC to extend its deal for production cuts, and even the impact of growing renewable energy production. Falling yields may simply be an outcome of temporarily weak inflation readings and ongoing central bank buying. Europe seems on the mend and growth elsewhere in the world seems strong enough to power earnings higher. Yet if the expected profit surge doesn't materialize and if central banks, rather than bailing out faltering markets, decide they need to find a way to stand on their own, today's low volatility after nine years of strong gains might be a calm before a storm.