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Christian Brothers Investment Services

MARKET PERSPECTIVE 4Q 2017

Another Very Strong Year

Catholic Responsible Investing

2017 CAPITAL MARKETS REVIEW

Strong Global Performance
U.S. Equities Performance
Fixed Income Performance
Synchronized Economic Growth
Moderate Inflation
Growth Continues to Dominate Value
Bond vs. Equity Valuations

MARKET MUSINGS

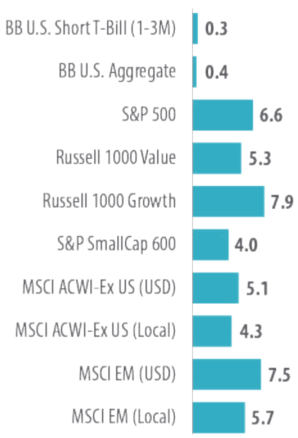
Impact of Tax Reform
Value Regains Dominance Over Growth
Inflation
Separatist Movement in Spain
Saudi Arabia
Israel and Palestine

The year ended on a remarkably strong note, with fourth quarter performance echoing the same story we have been telling for several quarters: Equities performed well across the globe, and large growth stocks dominated value and small cap, as we continue one of the longest periods of growth outperforming value on record.

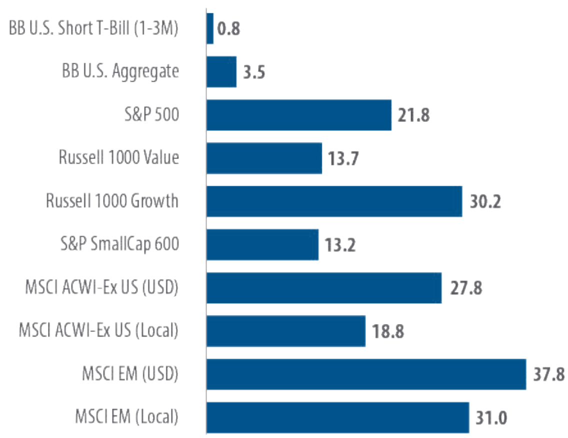
2017 Capital Markets Review

STRONG GLOBAL PERFORMANCE

Market Performance: 3 Month



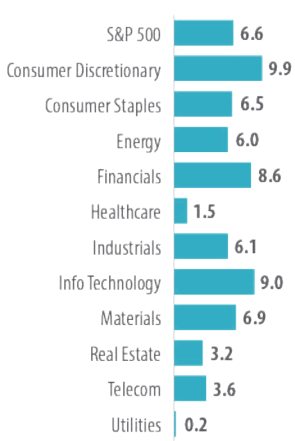
Market Performance: 12 Month



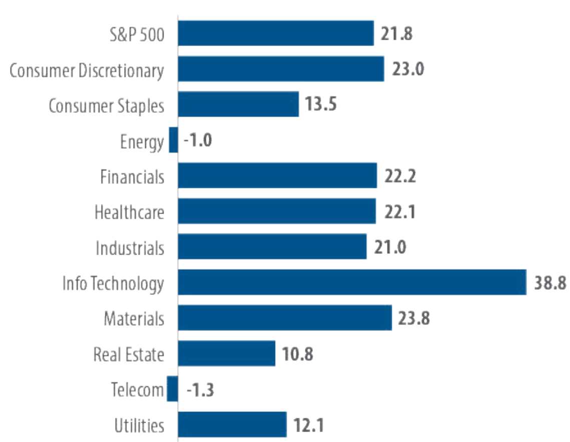
- Equity returns exceeded expectations across the board in 2017.
- While a weaker dollar boosted non-U.S. stock performance for U.S. investors, local currency market returns were also competitive with U.S. markets.
- Other market trends remained intact, with growth outperforming value and large cap outperforming small cap; these remain headwinds for active manager performance.

U.S. EQUITIES PERFORMANCE

Market Performance: 3 Month



Market Performance: 12 Month

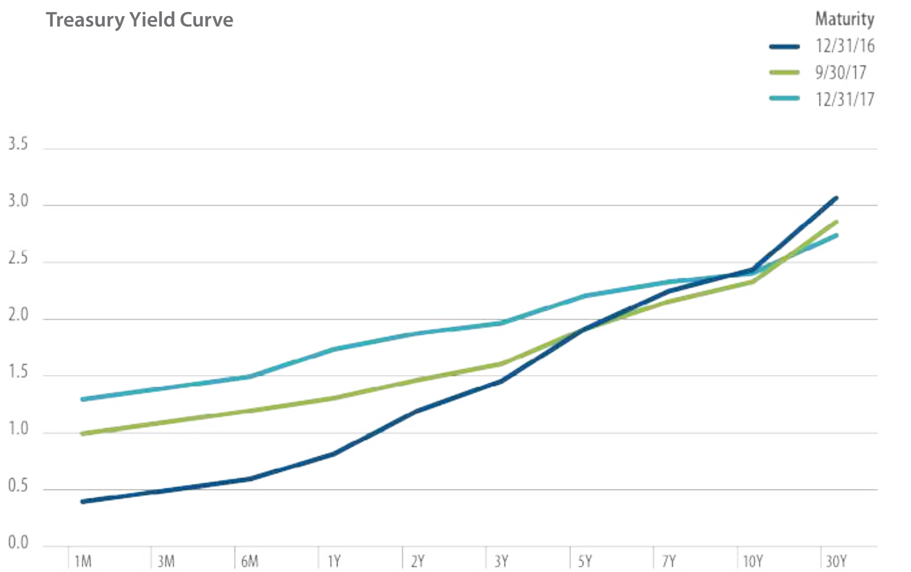


- Market commentators highlighted the low level of equity volatility, but in fact we did see volatility below the surface.

For the year, **Information Technology led the U.S. market** while Energy and Telecom lagged by approximately 40%.

FIXED INCOME PERFORMANCE

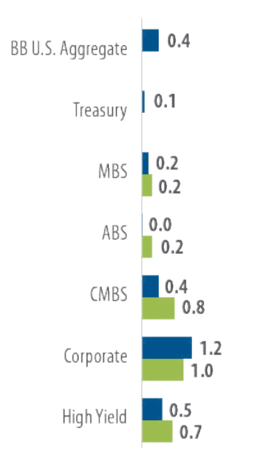
Treasury Yield Curve



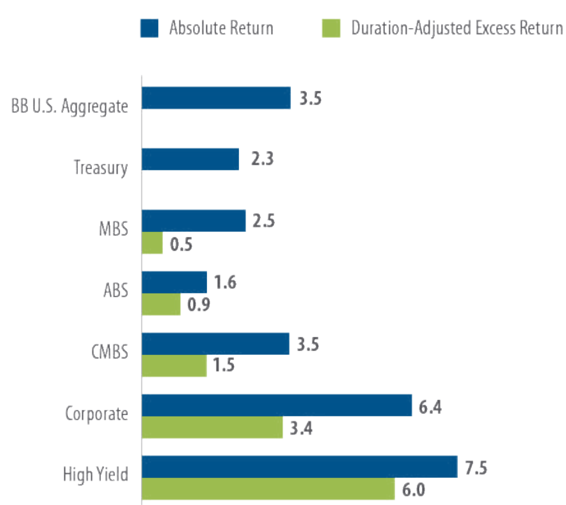
- The fixed income yield curve flattened as a result of Federal Reserve tightening.
- The long end of the Treasury curve was supported throughout 2017 by modest increases in inflation numbers.

Reflecting the strength of the equity markets, corporate bonds—both investment grade and high yield—generated significant outperformance versus Treasuries on a duration-adjusted basis.

Market Performance: 3 Month



Market Performance: 12 Month



- Concerns regarding higher yields and increased market volatility dampened the performance of the mortgage sector.

SYNCHRONIZED ECONOMIC GROWTH

U.S., Eurozone, and Japan: Economic Growth

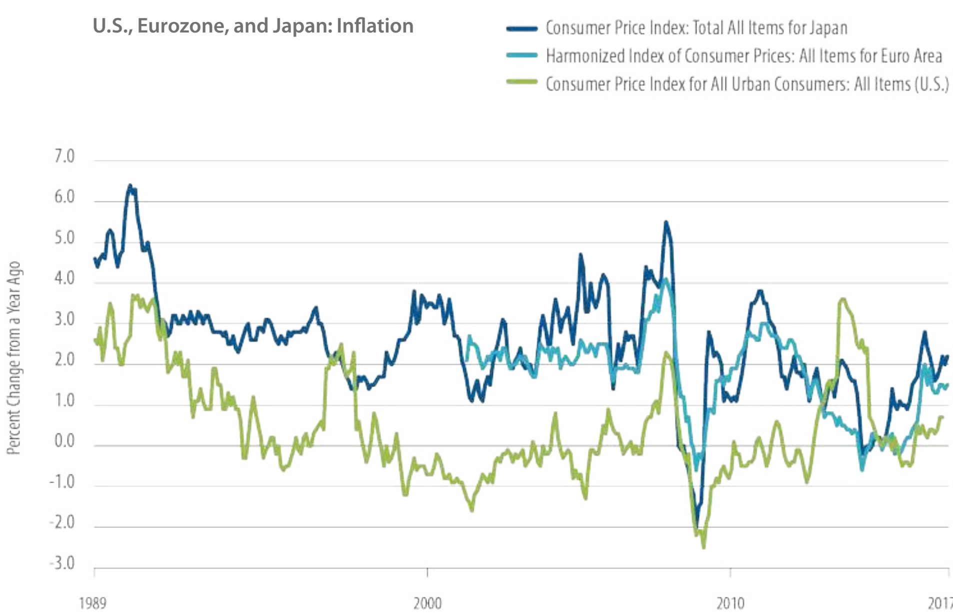
Source: BEA, Eurostat, JP. Cabinet Office , via Federal Reserve Economic Data, as of 12/31/2017; www.myf.red/g/hka0

- The world is beginning to show signs of synchronized growth rates.

This trend is positive for corporate earnings, and U.S. companies are expected to post **higher earnings growth** as a result of tax reform.

MODERATE INFLATION

U.S., Eurozone, and Japan: Inflation

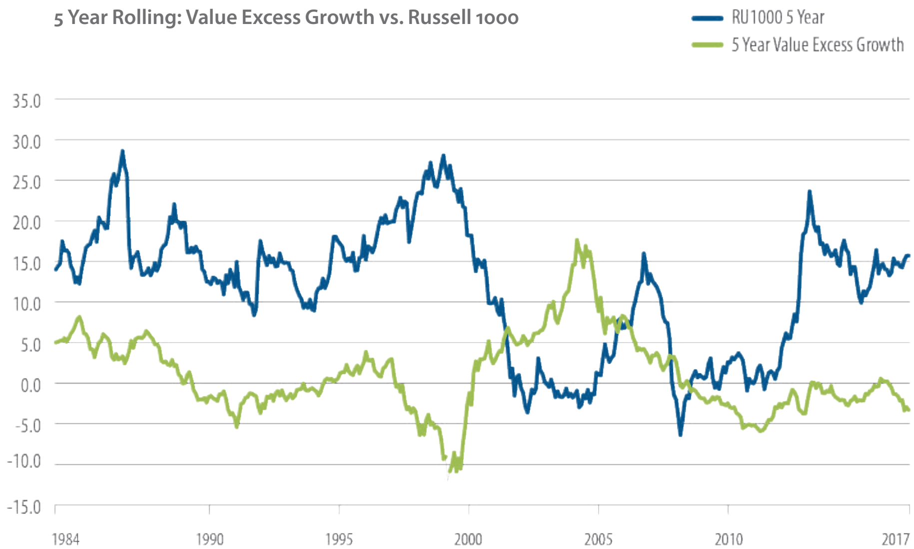


Source: BLS, Eurostat, OECD, via Federal Reserve Economic Data, as of 12/31/2017; www.myf.red/g/hkal

- While we are nowhere near an inflationary spiral, inflation numbers have increased globally and are also becoming synchronized.
- Fears of deflation have subsided, setting the stage for continued Federal Reserve interest rate hikes and a reduction in quantitative easing in both Europe and Japan.

GROWTH CONTINUES TO DOMINATE VALUE

5 Year Rolling: Value Excess Growth vs. Russell 1000



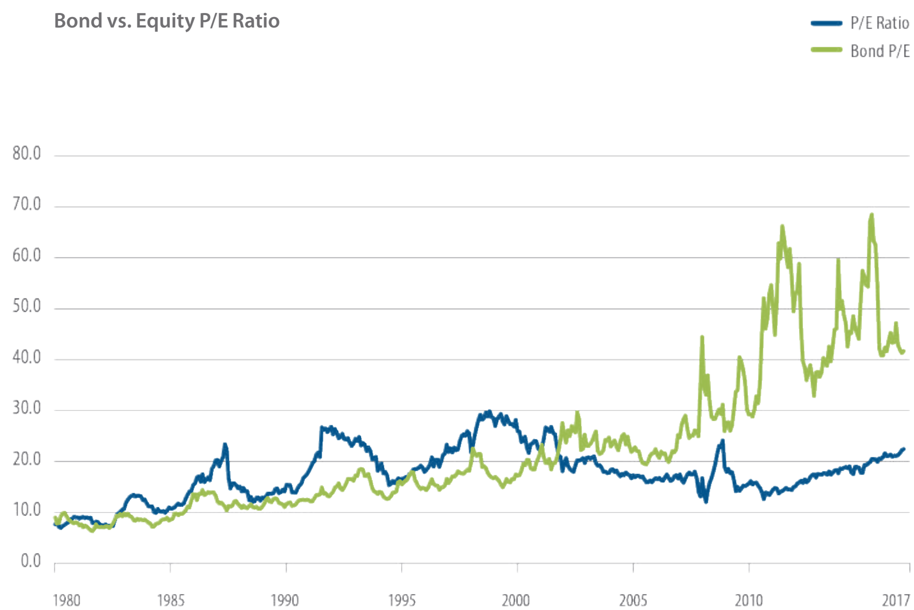
Source: Bloomberg as of 12/31/2017; www.Bloomberg.com

Growth has outperformed value for one of the longest periods on record.

- Value investing is anticipated to become the new vehicle for "defensive investing," replacing the bond substitutes of high dividend investing.

BOND VS. EQUITY VALUATIONS

Bond vs. Equity P/E Ratio



Source: Bloomberg as of 12/31/2017; www.Bloomberg.com

- The sustained market rally has stretched equity price-to-earnings ratios relative to history.
- We must be prepared for normal market corrections (10-20%), yet relative equity valuations do not portend a long bear market.
- Bond P/E ratios tend to follow equities; equities tend to trade at higher P/E values due to potential earnings growth.
- The Fed's reaction to the NASDAQ and housing crashes changed that relationship; bonds now trade at a clear valuation premium to equities.
- Until this market distortion ends, equities could trade at P/E levels historically considered rich.
- Higher earnings expectations support current valuations.

Market Musings

John Kenneth Galbraith purportedly said something along the lines of "the only purpose of economic forecasting is to make astrology look respectable." Rather than contributing to astrology's respectability, I will avoid economic forecasts and will attempt to outline some of the risks I see impacting markets in 2018.

Impact of Tax Reform – It came down to the wire, but Congress passed a tax package before year-end. There is no doubt the reduction in corporate tax rates is a welcome development, bringing the taxation of corporate profits in line with other countries. This change can not only make U.S. companies more competitive but—more importantly—remove some of the incentives for them to pursue non-economic activities, such as tax inversions and issuing U.S. debt while maintaining large offshore cash balances.

However, for all the positives of corporate tax reform, the little voice inside is whispering: beware the unintended consequences. The debate surrounding this tax bill was relatively benign compared to previous legislation. Lingering questions:

- What is lurking behind the details that may provide perverse incentives?
- Will the nascent housing recovery collapse?
- How will high-tax states, which are beleaguered by unfunded pension systems and stressed budgets, fare if we see the migration of productive workers to more "tax-friendly" jurisdictions?

Unfortunately, the tax bill made little progress toward simplification. The purpose of federal taxation is to provide revenue for the U.S. government, yet we are left with potentially more inefficient tax-driven behavior as individuals and corporations wade through the implications of this legislation.

Value Regains Dominance Over Growth – At some point, the trend of growth outperforming value will reverse. My concern is that when this occurs, it will be in the face of a market downturn. Should value investors be careful what they wish for?

Inflation – After close to two decades of dormancy, without a meaningful uptick for close to 40 years, will inflation become a concern? After all, inflation in Japan is starting to show positive readings.

Separatist Movement in Spain – Will they or won't they? And what will be the impact on the eurozone, both from an economic standpoint (probably little) and in terms of the euro itself? How many challenges can the currency survive?

Saudi Arabia – Lower oil prices are beginning to take a toll. Will there be political and social unrest in the kingdom as the government seeks to increase non-oil revenue? A shift in the balance of power in the Middle East bears watching.

Israel and Palestine – Despite predictions to the contrary, perhaps the recognition of Jerusalem as the capital of Israel will indeed bring about a peaceful resolution with Palestine. We hope, but remain vigilant.

In closing, as corporate earnings continue to improve, the valuation of bonds leaves stocks relatively attractive despite Fed tightening. The base case remains: modest returns from equities driven by increased earnings. Yet the old adage remains: beware the bus you don't see.

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