CBIS®
Christian Brothers Investment Services

MARKET PERSPECTIVE 1Q 2018

The Return of Volatility

Catholic Responsible Investing

CAPITAL MARKETS REVIEW

Global Overview
U.S. Equity Markets
Fixed Income Markets
Inflation Moving Toward Fed Target
Wages Finally Increasing
Growth Still Dominating Value
Gap Narrows Between Bond & Equity Valuations

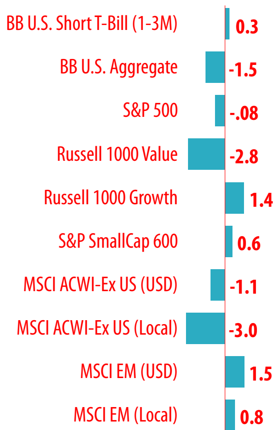
MARKET MUSINGS

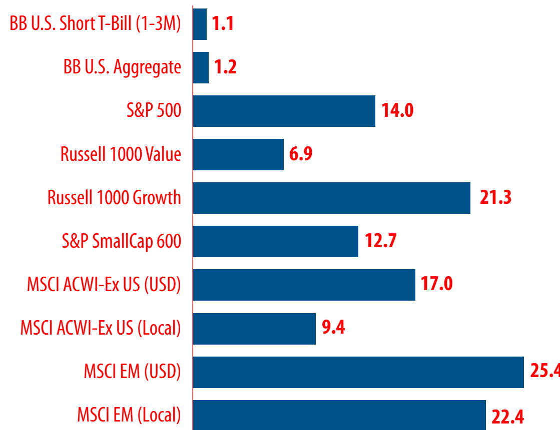
Era of Low Equity Volatility Ending
Normalizing Interest Rates
Low Unemployment & Labor Participation
Trade Fears: Globalization Is Real

Volatility has returned to equity markets, but despite the turbulence, the overall market saw only modest declines in the first quarter, with the S&P 500 Index down by less than 1%. A number of economic signals and policy factors, including normalizing interest rates, drove the change in volatility—which may signal an opportunity for disciplined investors.

Capital Markets Review

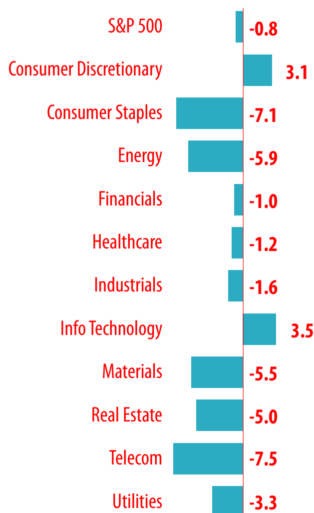
GLOBAL OVERVIEW

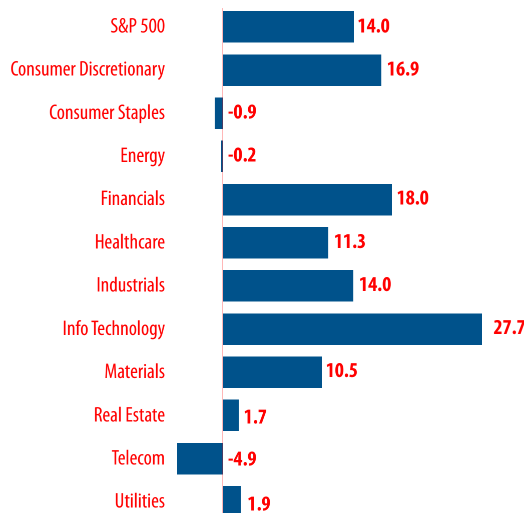




- Despite increased equity market volatility and headlines about the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google), U.S. growth stocks kept advancing while value stocks lost ground.
- In the last 12 months, growth has outperformed value by almost 15%.
- Small caps outperformed larger cap stocks for the quarter, driven largely by concerns over tariffs and a resulting trade war.
- Emerging markets stocks outperformed developed markets in local and dollar terms.
- U.S. fixed income underperformed equities as interest rates increased across the curve during the quarter.

U.S. EQUITY MARKETS





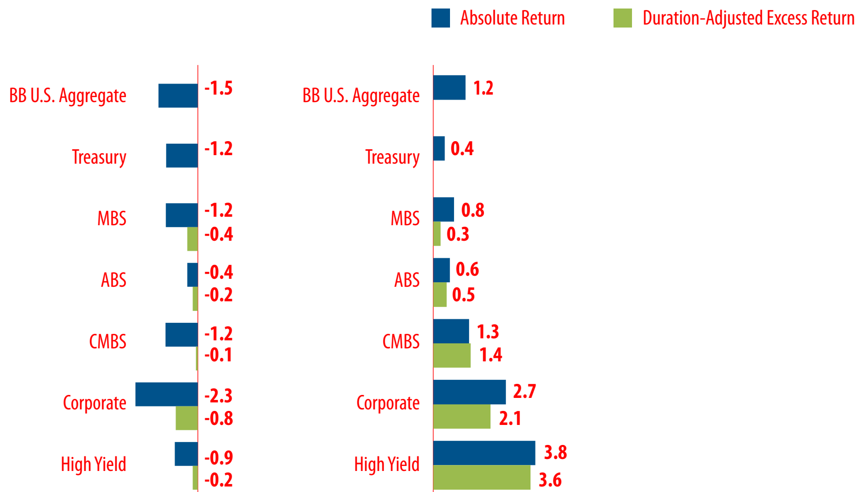
- Despite a weak March, the Information Technology sector generated the strongest performance during 1Q, followed by Consumer Discretionary.
- The Consumer Staples and Telecom sectors were relatively weak in the period.
- Over the last 12 months, only three of the 11 S&P 500 sectors outperformed the overall market.
- The Information Technology sector has provided market leadership for the last 12 months, followed distantly by the Financials and Consumer Discretionary sectors.

FIXED INCOME MARKETS

Treasury Yield Curve

Market Performance: 3 Month

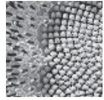
Market Performance: 12 Month



- While the yield curve has experienced a significant twist in the past 12 months, with the 30-year portion unchanged, it shifted upward in a parallel fashion in 1Q.

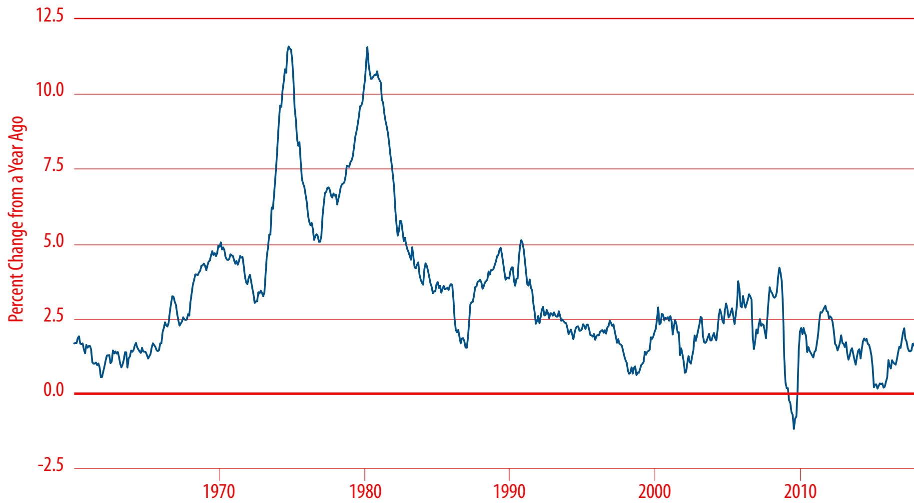
Duration and performance exhibited a linear relationship in 1Q, with long duration underperforming short duration.

- In contrast, long duration has outperformed shorter duration in the past 12 months despite an overall increases in yields.
- Credit and Asset Backed sectors underperformed Treasuries in 1Q, driven partly by increased market volatility.
- In the past year, sectors offering “equity-like risk” (e.g., High Yield bonds) were rewarded.



INFLATION MOVING TOWARD FED TARGET

Personal Consumption Expenditures Index

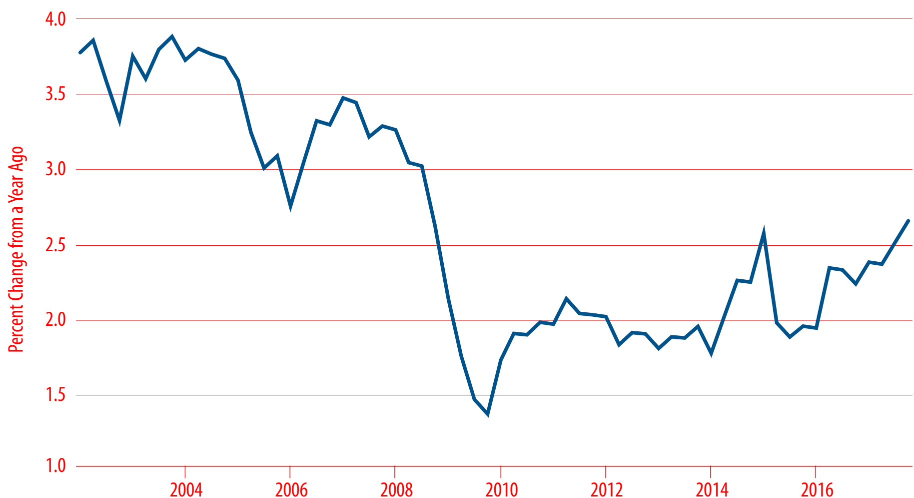


Source: U.S. Bureau of Economic Analysis, via Federal Reserve Economic Data, as of 3/31/2018; www.myf.red/g/iSGP

- The Fed's preferred measure of inflation, the Personal Consumption Expenditures Index, has moved toward the monetary authority's stated target.
- The Fed will welcome consistent readings between 2% and 2.5%.

WAGES FINALLY INCREASING

Employment Cost Index

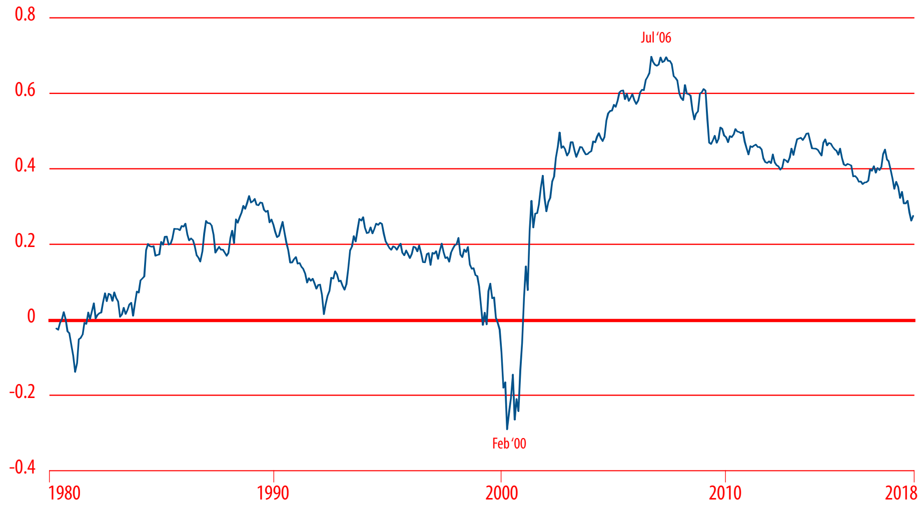


Source: U.S. Bureau of Labor Statistics, via Federal Reserve Economic Data, as of 3/31/2018; www.myf.red/g/jelQ

- Wage increases should be welcomed, not feared as inflationary.
- The rate of wage increase is well below historical norms, at levels economists generally consider "healthy."
- Further increases closer to 3.5%-4.5% would be a sign of stronger economic growth.

GROWTH STILL DOMINATING VALUE

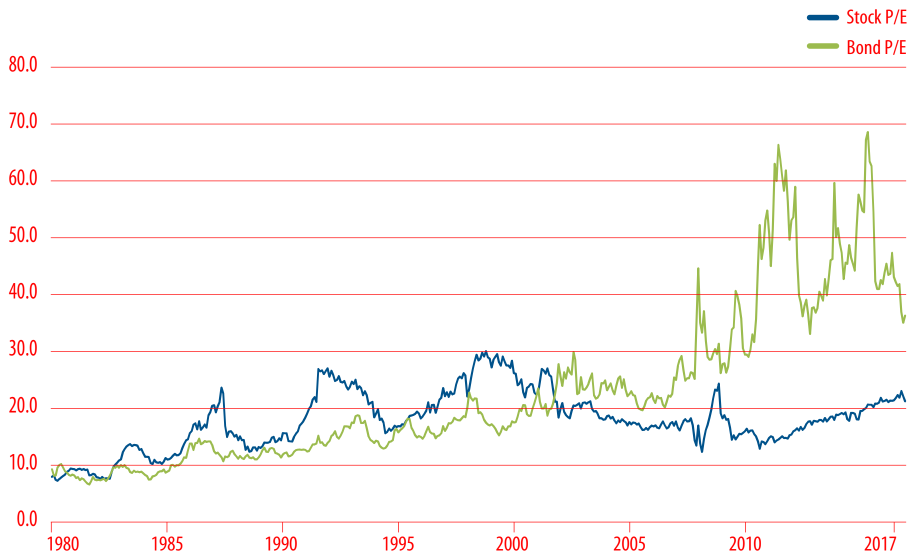
Relative Cumulative Added Value



Source: Bloomberg, as of 3/31/2018; www.Bloomberg.com

- Growth sectors continue to outperform value despite increased volatility; when will this trend turn?

GAP NARROWS BETWEEN BOND & EQUITY VALUATIONS



Source: Bloomberg, U.S. Department of the Treasury as of 3/31/2018; www.bloomberg.com, www.treasury.gov

- The gap between bond and equity price-to-earnings ratios has compressed; this trend is expected to continue.

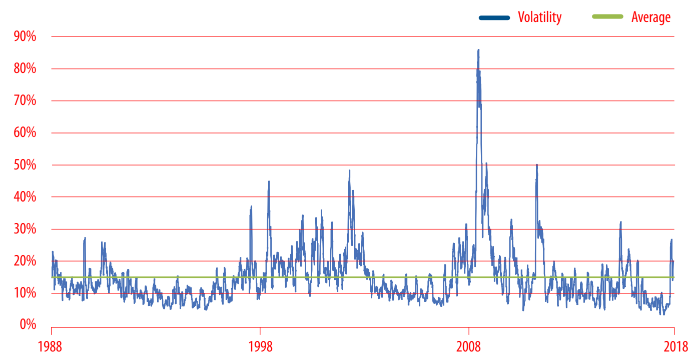
Market volatility will increase as the valuation difference narrows between these two asset classes.

Market Musings

"One of the great mistakes is to judge policies and programs by their intentions rather than their results." — *Milton Friedman*

Volatility has returned to equity markets, a development that should cause neither surprise nor apprehension. For most of the past six years, we have been in an environment characterized by low levels of volatility, caused in large part by historically low interest rates. The world's central banks engineered the low rate environment to stave off economic collapse in the face of the 2008 credit crisis and to prevent recession in the years of fragile recovery that followed.

Era of Low Equity Volatility Ending



Equity market volatility has remained below long-run averages for most of the period since the Global Financial Crisis, but we believe this period of tranquility is over as the Fed moves toward normalization of short-term rates.

Think of it as a program of life support—extreme measures applied on a temporary basis. Now the Federal Reserve has been quite eager to move its patient out of treatment and back to routine daily life. To do so, the central bank has been explicit in its desire to normalize interest rates, which means simply raising rates from levels near zero to somewhere in the direction of their longer-term averages. In the case of the federal funds rate, that's just under 5%. Over the past 16 months, Fed policymakers have approved a series of six 0.25% interest rate increases, lifting the targeted federal funds rate into a range of 1.50% to 1.75%. That's a significant move from zero, and while still a long way from the long-term historical average, it represents an extremely high percentage of change, coming as it does off a small base.

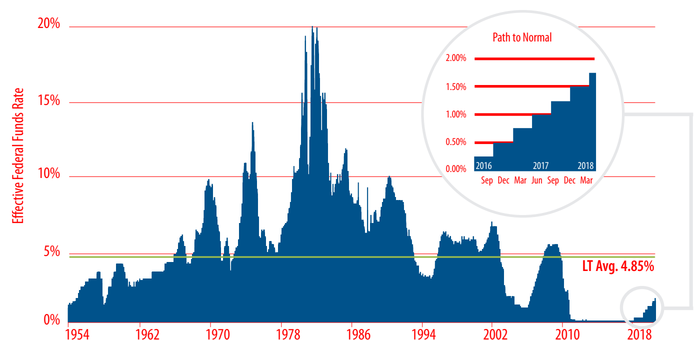
Thus the equity market volatility we witnessed in the first quarter was not unexpected. Rising interest rates represent change at the margin—in this case, higher borrowing costs for companies. Stock market investors consider that change and adjust their forecasts for the future profitability of companies. As a result, the relative attractiveness of individual stocks changes. Shares are traded. Repricing occurs. Volatility rises. All this happens so we can return the monetary system to the normal footing we require for the economy to function sustainably.

This increased volatility signals opportunity for disciplined investors. It exacerbates valuation differences and increases the potential for market mispricing of securities. This provides the potential for outperformance or alpha by active asset managers. At the portfolio level, volatility provides opportunities for improved outcomes for investors who follow a disciplined rebalancing process. In this case, market volatility encourages investors to "buy low and sell high" through rebalancing. Of course, emotion and institutional decision-making may make this advice difficult to follow. Each of these characteristics serves to transform market volatility from a risk into an asset.

The larger concern for market returns is not the increased volatility, but the potential for policy mistakes from well-intentioned actions and initiatives. This is where the quote from Milton Friedman comes into play.

There is no doubt in my mind the Federal Reserve is on the correct path by normalizing interest rates. In doing so, the Fed removes perverse incentives and potential risks from negative real interest rates. However, in forecasting the relationship between the unemployment rate and inflation in a 21st century

Normalizing Interest Rates

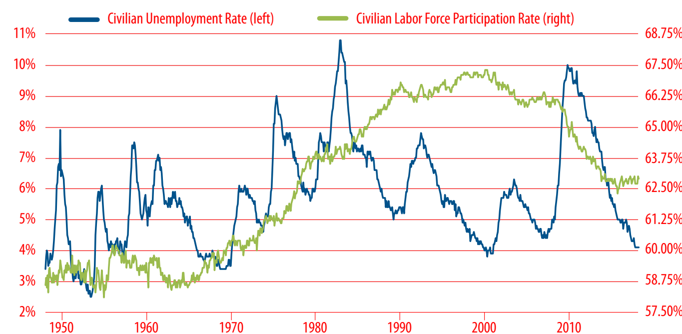


economy, members of the Fed's Open Market Committee risk overshooting—setting interest rates too high and triggering recession. Certainly this fear permeated the market in early February as a result of a strong employment report, a short-term increase in long-term bond yields as a result of increased inflationary expectations, and the first shot of higher volatility.

Shouldn't we welcome higher wage growth? We have been waiting for this for years. Yes, the unemployment rate is low, and maybe it is close to a level that will spur inflationary wage increases. But, we cannot overlook the fact that the labor participation rate is also low and has not increased. The unemployment rate only factors in those individuals that are actively seeking employment, not those who have given up the job search. The low participation rate points to a supply of potential workers who are not currently seeking employment. With an increase in wages, is it not likely that some of the frustrated job seekers will re-enter the work force? That increase in the supply of labor could mitigate wage inflation. Wage growth remains below historical levels, and while we must always remain vigilant for inflation, at this point it remains a risk—not a reality.

A trade war presents an even greater threat to the market outlook. Trade is an ever-increasing percentage of world economic growth, with significant profits earned by U.S.

Low Unemployment & Labor Participation

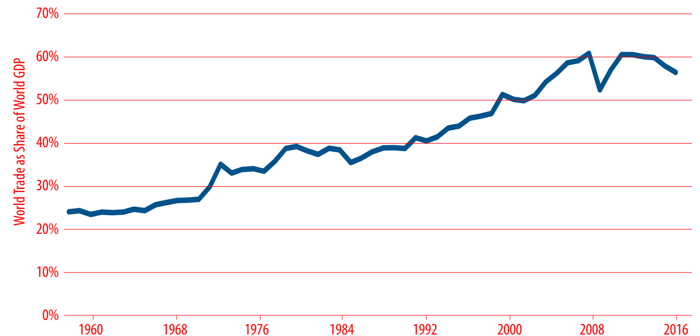


Source: U.S. Bureau of Labor Statistics, via Federal Reserve Economic Data, as of 3/31/2018; www.myf.red/g/jeH4

Inflation fears in 1Q were based on the Phillips Curve Theory, which holds that unemployment and inflation have a stable, inverse relationship. However, the decline in the participation rate—particularly post-2008—can be viewed as a mitigating factor to offset Phillips Curve concerns.

corporations in foreign domiciles. Trade is not a "you win, I lose" proposition but rather a "win-win" or "lose-lose" equation. The dollars we spend on imports find their way back to the U.S. to purchase goods, services, or government debt to support our economic growth. Where else would the dollars

Trade Fears: Globalization Is Real



Source: World Development Indicators, as of 3/1/2018; databank.worldbank.org

Trade makes up more than 50% of global GDP; an outbreak of trade wars has the potential to harm both economic growth and corporate earnings in the U.S.

go? Unfortunately, tariffs simply increase the cost of the good or service. As with any product, increased prices result in reduced demand. The market reaction to the trade rhetoric is well-placed, and we anticipate continued volatility as these policies play out.

We have been fortunate to have low market volatility through the period of rehabilitation of global economies in the aftermath of the Financial Crisis. Now as economic growth is becoming more robust, monetary authorities are moving towards normalization of policy. This is a positive development that includes higher market volatility with all its risks and benefits.

John W. Geissinger, CFA
CIO, CBIS

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.*