CBIS
Christian Brothers Investment Services

1Q 2015

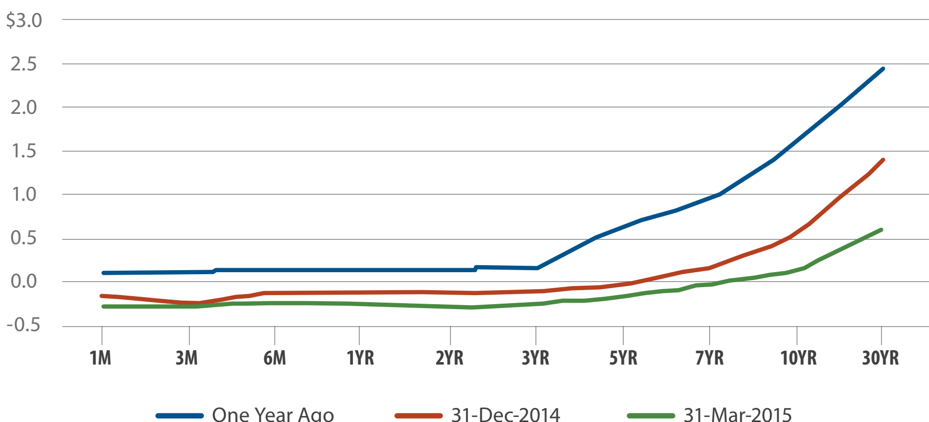
Market Overview

KEEPING FAITH IN CENTRAL BANKERS

Late last year the European Central Bank ("ECB") promised it would soon undertake securities purchases, known as quantitative easing, in an effort to stimulate the chronically weak Eurozone economy. It did not disappoint. In late March, the ECB said it will buy 60 billion euros of bonds monthly for at least the next 18 months until it is assured inflation is near its 2% target rate (Eurozone inflation is now slightly negative partly due to the collapse in oil prices). Spurred by enthusiasm over the ECB's move, developed European markets gained nearly 20% measured in euros during Q1. But strength came from more than just the ECB.

The long-depressed Eurozone economy gave hints of life and euro currency weakness — down about 10% versus the U.S. dollar through Q1 and more than 25% for the trailing year — boosted prospects for better exports. Positive hints emerged early

GERMANY TREASURY YIELD CURVE (31-MAR-2014 TO 31-MAR-2015)



Source: FactSet

Market Summary

- The European Central Bank's promise of Quantitative Easing came to fruition in March; this led to strong gains for European equities
- Weaker Euro spurred hopes for stronger European exports; German stocks were notably strong, gaining 22% in Euros
- Strong U.S. dollar led to preference for small-cap domestic vs large companies with overseas operations
- Growth substantially outperformed value across sectors; strong gains by Apple and in biotech stocks; performance was hurt by weakness in oil companies, which account for a much heavier weight in value indices
- The long end rallied as investors sought "high yielding" U.S. assets
- U.S. economy appears to have found traction for sustainable growth; now one of highest-yielding developed nations; overseas capital permits domestic yields to remain below levels justified by fundamentals

in Q1 when Eurozone Q4 GDP growth figures surprised on the upside. Economists also cited stronger-than expected credit growth late in Q4 into Q1 as a hint that the continent's economy maybe turning a corner. But Eurozone growth was still far from strong, up only 0.3% quarter-to-quarter compared with an expected 0.2%, and a stronger dollar constrained European market gains for U.S. investors to the high single digits. Emerging markets lagged, with a 2.5% gain in U.S. dollar terms. Investors are concerned that Fed tightening and prospective rising U.S. yields may lead to money flows out of EM nations, where there's been large corporate borrowings in U.S. dollars and where commodity price weakness is taking a toll on economies. Brazil was particularly weak, down 14% in U.S. dollar terms, impacted by political turmoil surrounding the Petrobras scandal, a recession and a weak currency.

Low valuations boost Japan

Japan was another source of global market strength, gaining about 10% in both local currency and U.S. dollar terms. A number of institutional asset managers noted the appeal of Japanese equities' low valuations relative to the U.S. and other regions as well as hopes that "Abenomics" — Japan's massive government stimulus to end deflation and spark growth — would work. Japan's government has also been massively supporting markets. Press reports indicated that Japan's national pension system, postal bank and central bank are all buying Japanese shares.

U.S. sees growth lead value

U.S. equities were flat for the quarter, with single-digit positive returns from growth stocks offsetting slightly negative results from value stocks. For the trailing 12 months, however, growth outperformed value by about seven percentage points, and while the consistency of growth's outperformance was striking, it was focused in a few specific areas. Apple surged 65% and represents nearly 6% of the Russell 1000 Growth benchmark and only 0.3% of the Russell 1000 Value; that alone produced over 200 basis points of excess return for the growth index. Collapsing oil prices hit the value index much harder than the growth index. Oil & Gas companies, which account for almost 12% of the value benchmark weight and only 3% of the growth bench, declined about 10% due to last year's oil price collapse. This cost value about 150 basis points in relative return. Finally, biotech surged about 40%, benefitting growth far more than value. Biotech has a 5% weighting in growth benchmark and nearly zero in the value benchmark; this gave growth more than 150 basis points in relative return. Growth produced other pockets of relative strength but these were the focal points.

As has been the pattern in recent years, forward-looking earnings estimates for U.S. companies generally came down as the quarter progressed and this acted as a depressant on U.S. equities. The strong dollar was cited as a prime cause this time, as U.S. overseas earnings get reduced when translated back to dollars. But independent of currency effects, the domestic economy has failed to gain long-expected momentum and a lack of corporate investment, the labor dispute at the West Coast ports, a particularly harsh winter in some parts of the country, a drag from trade and slower inventory accumulation were noted by economists late in the quarter as augers of a likely weak Q1 GDP report. Generally slow global growth, despite the hints of strength in Europe, also has taken a toll on earnings expectations for multi-national U.S. companies.

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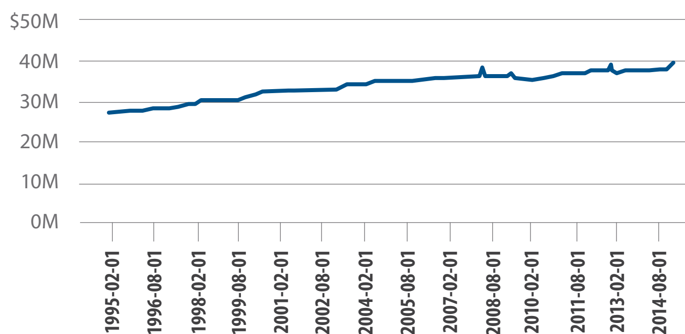

Source: Federal Reserve

U.S. bonds continued to defy the "fundamental gravity" that most investors had expected would materialize by now as a natural condition of a stronger U.S. economy and rising market yields. Instead, rates declined slightly during Q1 as economic reports came in weaker than expected and global investors turned to the relatively high yields of US fixed income securities. Investment-grade spreads were little changed, however high-yield spreads actually compressed somewhat, surprising those who believed the energy sector's woes and a softening economy would produce the opposite effect. The Federal Reserve's March Federal Open Market Committee (FOMC) statement indicated economic conditions have moderated somewhat since January, but it still sees continued labor market gains and moderate growth for the year. It reaffirmed that any rate rise would require further improvement in the labor market and better confidence that inflation will move back to the Fed's 2 percent target over the medium term.

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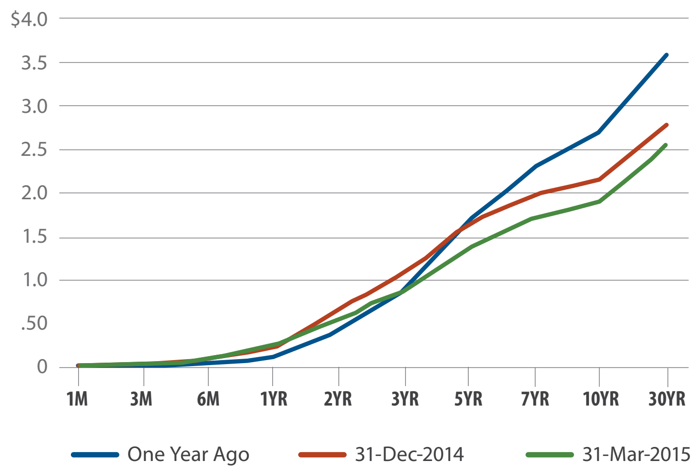
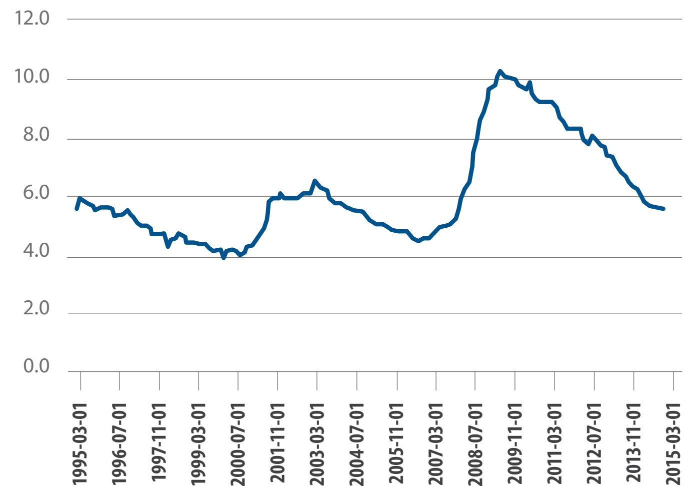


Source: FactSet

UNEMPLOYMENT RATE



Source: Federal Reserve

Outlook

There seem to be two fundamental wildcards facing global investors as markets enter the mid-stretch of 2015. Will the hints of growth evident in Europe during the winter build to an enduring economic recovery or will they prove to be noisy data in a long-running and seemingly endless recessionary economy? In the U.S., will growth find traction after what looks to be a weak Q1 and will optimistic earnings prospects hold up for 2016 — now expected to produce about 12% gains across the S&P 500?

Sharply lower oil prices would argue for optimism, acting as a general stimulus for consumption in developed-market economies where gasoline forms a significant part of household budgets. A second argument for optimism, not only for economies but for global financial asset prices, is the massive support forthcoming from most developed market central banks. The ECB and Bank of Japan are both in stimulus mode while the US remains accommodative despite market expectations of a gradual increase in policy rates starting some time later this year. Indeed, 90% of global industrialized

nations have central bank policy rates near or below zero, a historically unprecedented circumstance that certainly forces many investors farther into risky assets than they would perhaps wish to go in order to find yield of any kind.

In the aftermath of the global financial crisis of 2008/2009, the U.S. economy mounted the swiftest recovery and has remained, since then, the most dependable source of global growth. This, along with near-zero rates across Europe, is one reason for the U.S. dollar's strength, and that strength seems likely to continue, with doses of volatility, well into the foreseeable future. Only a resurgent Europe would challenge dollar dominance and that prospect seems still too tenuous to pose a threat.

Otherwise, investors are cautioned to remain well diversified and positioned for a number of possible market outcomes. Low to near-zero yields and central bank support can lift risk assets' values to surprising heights and offer the illusion of deep market liquidity, but that liquidity can dry up fast and the value of financial assets can plummet if confidence in growth falters or if the belief in the omnipotence of central bankers (which has been so persistent since 2008/2009) itself falters. Mario Draghi had only to utter the words "whatever it takes" in summer 2012 to defer a continent wide financial melt-down. At some point however, real world fundamentals need to show convincing strength. That seems to be the central question facing markets over the course of this year: Will central bank liquidity stimulate the real economies or is it back to recession and back to the drawing board for global economic policies? If the former, then markets may well grind higher and higher. If the latter, then downside surprise with surging volatility seems inevitable.

Important Information

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