CBIS

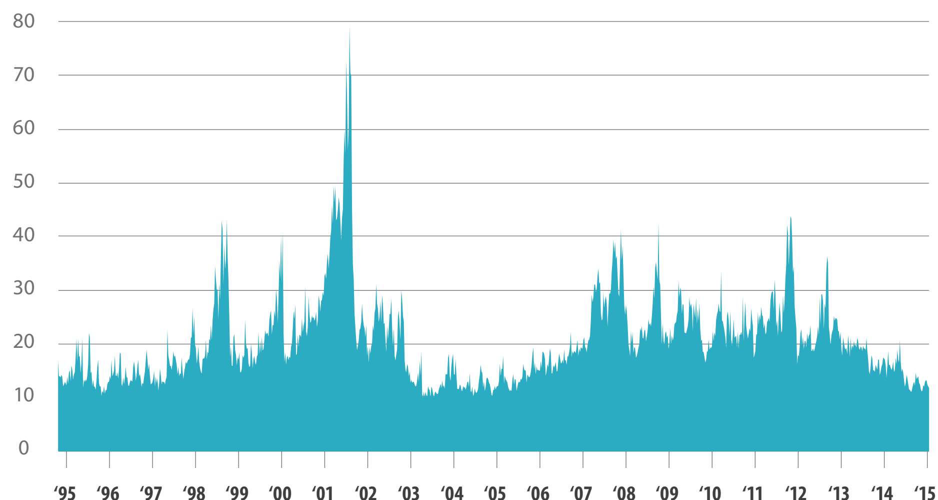
2Q 2015

Market Overview

BRACING FOR VOLATILITY

Global equity markets drifted sideways during most of Q2 as economic data confirmed expectations for improvement in Eurozone economies and in U.S. growth after a weak first quarter, which was blamed on very cold weather and labor disputes that slowed shipments at west coast ports. The only global equity market drama occurred on the last days of June when Greece's negotiations with European creditors broke down after Prime Minister Alex Tsipras insisted the Greek people vote on bailout terms and Greece missed a scheduled payment to the International Monetary Fund (IMF). Global markets were shaken as investors had expected a last-minute compromise and the quarter ended with downside volatility.

CBOE VOLATILITY INDEX



Source: FactSet

Market Summary

- The U.S. Treasury yield curve steepened in Q2 as economic growth rebounded from a weak Q1.
- Corporate spreads widened in Q2, and investment-grade corporates underperformed Treasuries despite improved economic fundamentals and a stable equity market.
- Despite volatility caused by Greece and China at quarter end, the U.S. equity market was relatively flat.
- European equity markets were buffeted by volatility at the end of Q2 after a breakdown in debt negotiations with Greece. The Japanese market continued to outperform due in part to the prospect of continued aggressive support from the government.
- Emerging market returns in Q2 were generally positive. China experienced a strong run-up in May. Russia and Brazil rebounded after severe losses earlier in the trailing 12-month period.

In local currency terms, Ireland (4.63%) was Europe's strongest market, followed by Norway (1.42%). Austria (-0.36) was next, with all other European markets in the negative. More broadly, the global developed market benchmark, MSCI EAFE, returned -1.6% in terms of local currencies, while the MSCI Emerging Markets Index gained 0.8%. The U.S. dollar rally stalled in Q2 as the U.S. currency fell about 4% against the euro, 6% against the British pound and about 2.5% against the Swiss franc. The dollar gained only against the Japanese yen, extending its year-long rally with a 2% gain. As a result, returns were marginally enhanced for U.S. dollar-based investors; in U.S. dollar terms, both the MSCI EAFE Index and the MSCI Emerging Markets Index were nearly flat for the quarter, each with about a 0.8% return. The MSCI All-Country World ex-U.S. Index returned just over 1% in U.S. dollars.

U.S. equity indices were largely unchanged, with both the S&P 500 and Russell 1000 returning just slightly over 0% with little difference between growth and value. The small-cap Russell 2000 Index returned 0.4%. Sector returns within the S&P 500 were fairly narrow; utilities (-5.8%) were weakest on a rise in interest rates, healthcare (+2.8%) was strongest, with other sectors clustering tightly around the broad index return.

Crude oil prices stabilized for most of the quarter around $60 per barrel, having bounced from a low near $40 per barrel in March. Economists credited the boost to consumer budgets produced by oil's collapse from more than a $100/barrel price last summer and the monetary stimulus provided by the European Central Bank's version of quantitative easing, which began during March, as an impetus to improving economic data in Europe as the quarter evolved. European exports have also been supported by the decline of the euro to a two-decade low against the U.S. dollar. Late in Q2, European business activity measured by the closely watched Markit purchasing managers survey rose to a 49-month high across the 19-country Eurozone and economists estimated Q2 quarter-to-quarter growth at 0.4% with a 2% estimate for 2015 as a whole, with broad-based albeit modest strength evident across the continent.

The U.S. economy also showed renewed strength after its winter stumble. Q1 GDP, which had originally been reported as down 0.7%, was revised upward to a decline of 0.2% and reasonably strong employment and consumer spending data as Q2 progressed led to consensus estimates that growth would recover to 2.6% in Q2 and about 3% over the balance of 2015. Consumer spending in May posted its largest monthly increase, at 0.9%, in six years on strong auto sales and other big-ticket expenditures, while employment and housing-related data also indicated a rebound from Q1 weakness. U.S. growth seems strong enough for the Fed to make its first hike to the Federal Funds rate in ten years later this year, with its September meeting seen as the most likely time if recent economic strength continues.

Japan's economy was weaker than expected during Q2 after 3.9% growth during the first quarter. Consumer spending, industrial production and exports were below expectation and caused some economists to reduce Q2 growth projections to zero. Weakness was generally attributed to a sales tax increase last year. Nevertheless, the government remains committed to aggressive stimulus to spur both economic activity and inflation, which remains near zero.

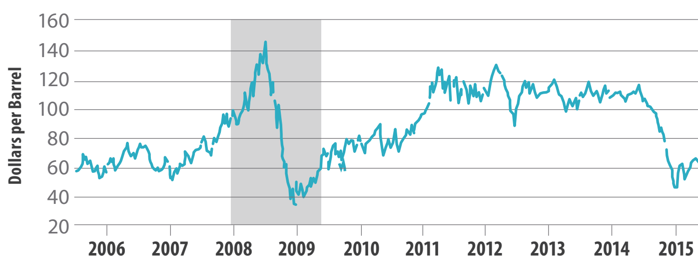
TRADE WEIGHTED U.S. DOLLAR INDEX: MAJOR CURRENCIES

Source: Federal Reserve Bank of St. Louis (FRED), Board of Governors of the Federal Reserve System (US)

While equity markets drifted trendless in Q2, European sovereign bond markets surprised investors with sharply rising yields, albeit from very low levels. The German 10-year government yield jumped from near zero in early April to almost 1% in June, Spanish and Italian 10-year government yields rose from just over 1% to near 2.5%, and the Portuguese 10-year jumped from 1.5% to 3%, all before backing off slightly as the quarter closed. The U.S. 10-year yield trend in Q2 was a bit more muted; it had reached a low of about 1.6% in February and climbed from just under 2% in early April to 2.4% by quarter end. In general, rising yields were seen optimistically as a natural consequence and confirmation of stronger economic data, even as inflation readings remained muted in both Europe and the U.S. — in both cases well below the Fed and ECB's general 2% target rate. In the U.S., shorter-term yields also drifted higher, with the five-year Treasury yield rising from a low of 1.2% in early April to 1.7% by quarter end. The two-year was a bit more muted, climbing from 0.5% to 0.7%. Credit spreads for lower-rated U.S. investment grade debt rose slightly during the quarter, from about 2.5% to 2.8%. High-yield spreads were little changed. Nevertheless, over the past year, credit spreads in the U.S. bond markets have climbed, with Baa spreads up from 2.2% to 2.8% and high-yield spreads up from 3.5% to 4.5% (after peaking at 5% in January of this year).

A more pessimistic take on the quarter's bond volatility highlights the lack of liquidity in bond markets, a result partly of banks withdrawal from market-making as a result of Dodd-Frank legislation restrictions on risk and partly due to aggressive central bank buying through QE programs. A *Wall Street Journal* article ("Why Liquidity Starved Markets Fear the Worst", May 20) profiled the problem, stating that the corporate bond market has doubled since the 2008/2009 crisis, to $4.5 trillion, yet bank trading desks hold only $50 billion of bonds compared with about $300 billion pre-crisis. The article also cited Deutsche Bank research that found U.S. Treasury trading volumes have fallen 10% since 2005 even as the size of the market has tripled, while a J.P. Morgan analysis said a trading position capable of moving the government bond market has fallen from $280 million to only $80 million over the past year. Scare stories are legendary in financial journalism; after all that's what grabs reader's attention. Yet after an unprecedented 90 months of zero short-term yields and with longer-term yields at the lowest levels in six decades, wariness about volatility likely to be attendant to rising rates is a prudent form of caution. CBIS bond funds are sub-advised by expert bond investors with the experience and analytical acumen to navigate any market environment well as anyone. But we suggest participants brace themselves for volatility as the Fed transitions to more traditional interest rate policy.

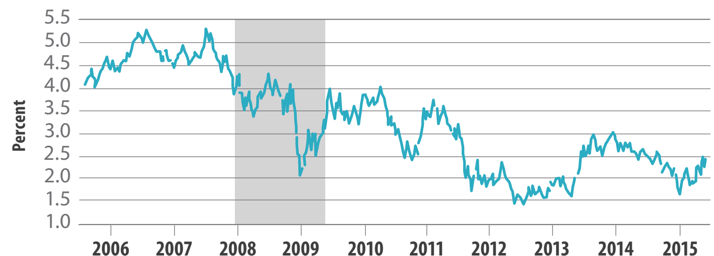
CRUDE OIL PRICES



Shaded areas indicate U.S. recessions

Source: U.S. Energy Information Administration and Federal Reserve Bank of St. Louis (FRED)

10-YEAR TREASURY CONSTANT MATURITY RATE



Shaded areas indicate U.S. recessions

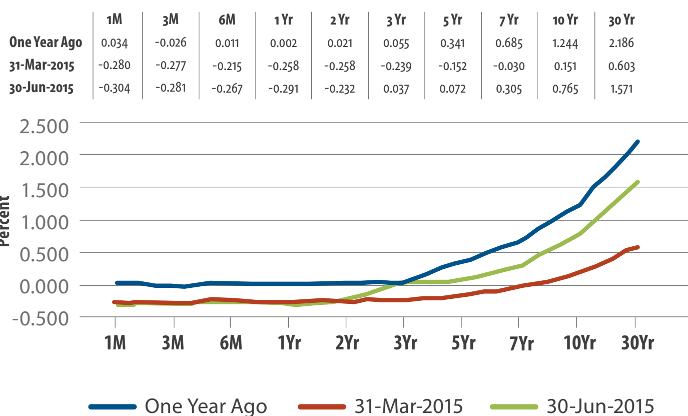
Source: Board of Governors of the Federal Reserve System (U.S.) and Federal Reserve Bank of St. Louis (FRED)

OUTLOOK

In the U.S., equity markets are likely to be reliant on corporate earnings growth rather than PE expansion to power further gains, with Fed policy shifting to a tightening bias and interest rates unlikely to drop further unless economic growth disappoints. Yet earnings growth is a bit hard to come by in a still-tepid six-year economic expansion that is already lengthy by post-WWII standards. S&P 500 profits rose only about 4% in 2014, according to Zack's (Zack's Earnings Trends, June 24, 2015) with 2015 gains projected at about 7% (ex the very weak energy sector); including energy, 2015 earnings growth is pegged at only 1%. The 2016 outlook is more bullish. Analysts' consensus expectations indicate about an 11% gain, which will clearly be reliant on the U.S. economy gaining its long-awaited, but so far evasive, traction for steady 3% growth. Moreover, stocks have been supported by record levels of share buybacks and extraordinarily strong merger & acquisition activity. The *Wall Street Journal* (Fear of Losing Out Drives Deal Boom, June 26) reports that merger activity this year is running at the fastest pace in nearly a decade. About $2.15 trillion in M&A deals or offers have been announced globally, according to Dealogic, making 2015 on pace to challenge the record $4.3 trillion in 2007. In another potential sign of market froth, NYSE margin debt reached a record high in April, overtaking levels that preceded the collapse of the 2001 tech bubble.

In the Q1 letter we remarked that markets had risen to ebullient heights partly as a result of a firm faith in central bankers, a belief that six years of zero rates and global easy money policies would stimulate economies enough to produce the earnings growth that would justify further market gains. Three months later and the situation remains pretty much the same. Investors have been lulled over six years of fairly steady market gains and low volatility into a "buy the dip" mentality and a forgetfulness that longer-term market advances come attendant with at times nerve-wracking downturns. The former has been delivered in recent years, but decidedly without the latter. We'd encourage CBIS participants to steel themselves emotionally for a return of volatility and harden their investment policies and their nerves to contend with it when it arrives. The path to higher rates is unlikely to be gentle, for either stocks or bonds. We do not say this to be bearish or foreboding. Instead, we urge you to establish and review your long-term investment strategies and prepare to use any market volatility to rebalance back to target weights. As Q3 begins, the equity markets have drifted trendless since late last year and bond yields seem to be drifting with a slightly upward bias. We urge participants not to try and guess what will happen next, but rather prepare for whatever the markets may deliver and employ disciplined rebalancing as a constructive response to any downside volatility.

GERMAN 10-YEAR GOVERNMENT YIELD (AS OF: 30-JUN 2015)



	1M	3M	6M	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	30 Yr
One Year Ago	0.034	-0.026	0.011	0.002	0.021	0.055	0.341	0.685	1.244	2.186
31-Mar-2015	-0.280	-0.277	-0.215	-0.258	-0.258	-0.239	-0.152	-0.030	0.151	0.603
30-Jun-2015	-0.304	-0.281	-0.267	-0.291	-0.232	0.037	0.072	0.305	0.765	1.571

Source: FactSet

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.