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Quarterly Review & Outlook

Commonwealth
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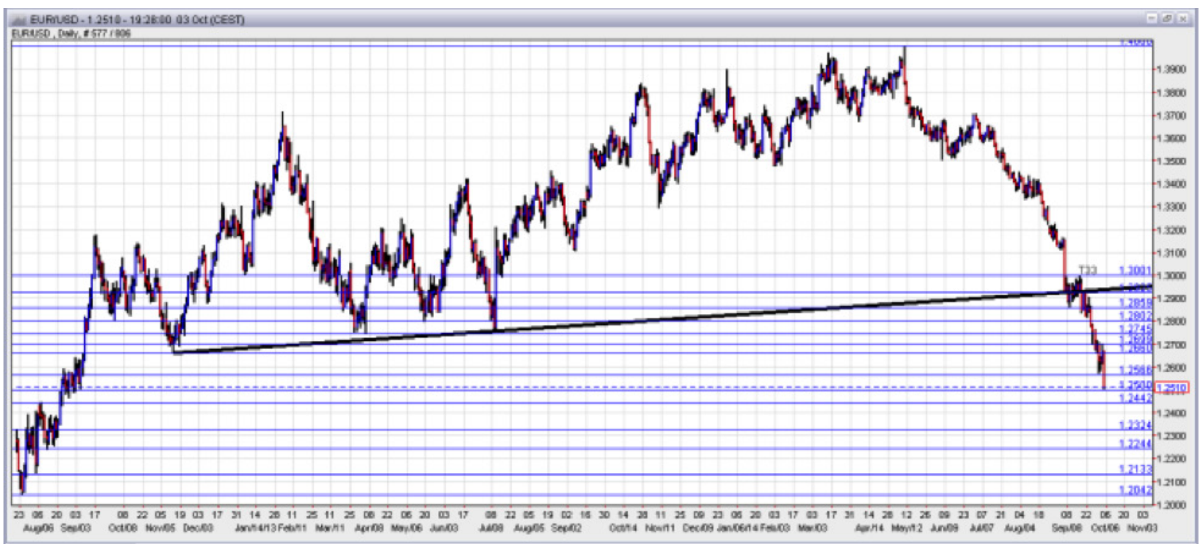
We have posted a presentation and slides on **www.CBandT.com** that provide a broader 3Q14 review and that correspond to parts of the Outlook below. In the following section, we answer questions frequently asked by our customers about the investment environment. – *The CBandT Investment Team*

Europe remains troubled and the Euro has fallen against the dollar, how will this affect markets?

Short answer: As Central Bankers in Europe, Japan, U.S. and China attempt to achieve their employment, GDP and inflation targets, the U.S. dollar is likely to remain strong against other currencies and the U.S. stock market should continue to rally.

Euro/USD Exchange Rate



We believe the economic environment and activity within Europe will be the key determinant for U.S. and global markets for the next six to twelve months. Collectively, the European Union is now the world's largest economy. Europe incrementally weakened through 2014. The latest September data indicate the Eurozone is growing 0.7%, while inflation is running 0.3% – well below the 2.0% target levels for both measures. Moreover, Germany, Europe's largest economy, disclosed that its economy contracted 0.2% in 2Q14 and may contract in 3Q14 as August production and exports fell almost 6%. Sanctions on Russian trade, which comprise over 6% of Eurozone and over 13% of German exports will intensify the decline. This places Europe on the edge of recession and, possibly worse, deflation.

On October 2, ECB President Mario Draghi announced an involuntary Quantitative Easing (QE) program to buy bonds from Eurozone banks to keep rates low and spur lending. The prior voluntary program, the targeted long-term refinancing operation (TLTRO), which offers cheap 0.25% loans to Eurozone banks for four years, will remain in place. Despite the cheap money, lending contracted 2% over the summer, while Eurozone GDP and inflation continued to drop. Another European bank capital test will be announced in the second half of October, which may encourage banks to lend if the test is favorable. The concern is Draghi's QE program may not be robust enough to prevent Eurozone deflation. In response to the weak results, the Euro has fallen 10% against the U.S. dollar and will likely stay depressed until the Eurozone economy improves.

Couple Europe with Japan, the fourth largest economy, and the global economy looks worse. After implementing monetary policy, legislating a fiscal stimulus, Japan's economy soared in 2013 as the yen fell 30%. Unfortunately, Prime Minister Shinzu Abe's government increased Japan's value added tax from 5% to 8%, cutting GDP growth to ~1% again. Without tax reform, the Yen may have to devalue another 10% for Japanese GDP to reach its 2% growth target.

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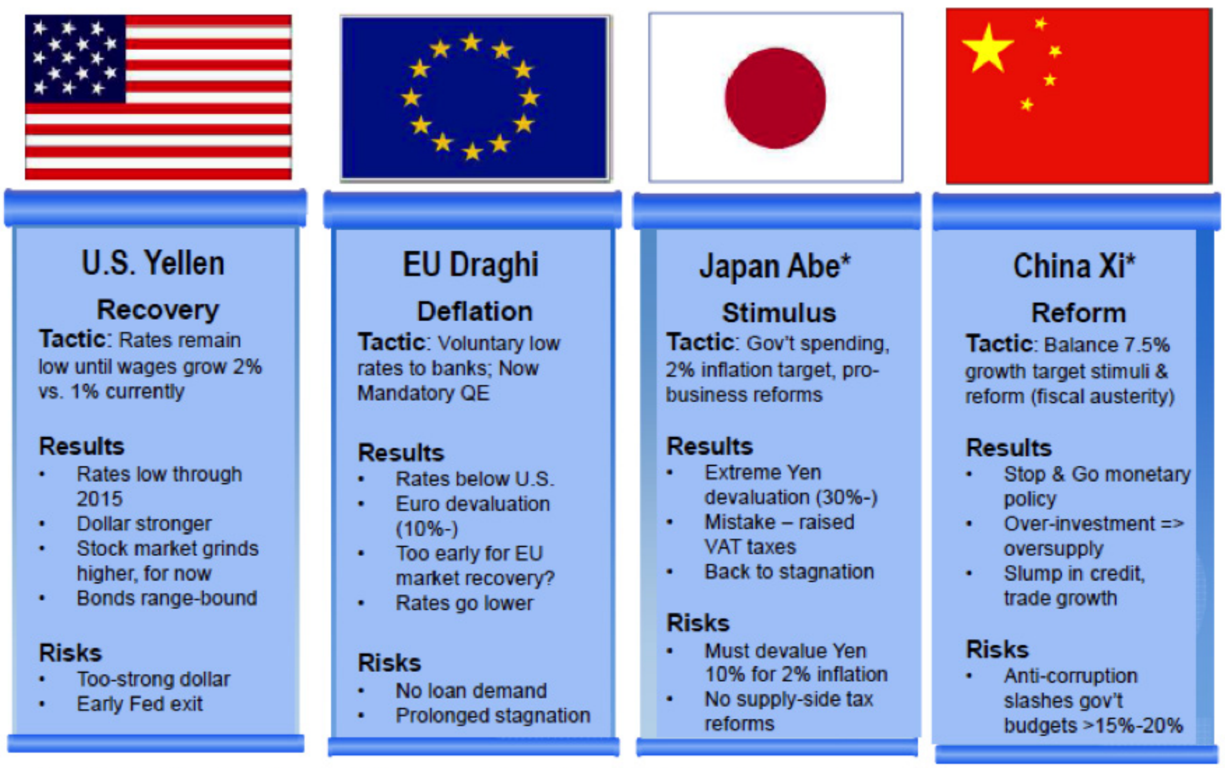
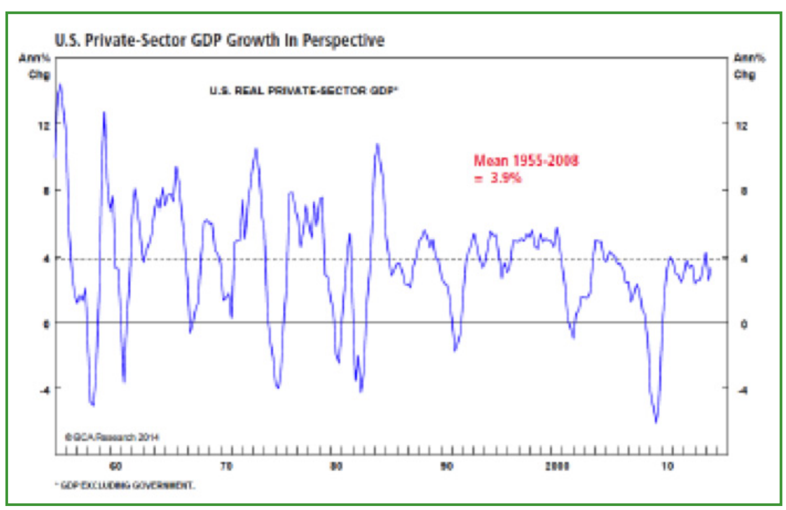
China continues to maintain its 7.0%-7.5% target growth rate, but President Xi Jin-ping is having to provide stimulus to balance his anti-corruption campaign. His reforms have imposed austerity resulting in operating budget cuts of 15%-20% across the Chinese government . The budget cuts infer governmental corruption runs 15%-20% and possibly explains why there are so many millionaires working for the government.



* Prime Minister Shinzo Abe and President Xi Jin-ping are not Central Bankers, but lead monetary policy in their countries.

The good news, on the other hand, is that the U.S. economy is broadening its recovery as jobs, housing and credit are improving. For the last five years U.S. GDP grew a little over 2%, but it is now poised for 3% growth. As the chart below demonstrates, private sector growth is approaching its historical 3.9% mean growth level. U.S. fiscal austerity negatively impacted GDP more than 2% in the last two years and now is expected to stabilize to a lesser 0.4% drag. We think GDP forecasts may be revised downward, if Europe and Japan continue to weaken and the dollar continues to rise significantly.



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The strong dollar has forced us to revisit some of our longer-term secular investment theses. As discussed in past updates, we believe that emerging markets (EM) offer the strongest return opportunities for the next decade as trade globalization enables EM populations to earn middle class incomes. For example, China has reached the relative level of income per capita that post-WWII Japan did in the 1960s. Japan grew at the same 7.0% to 7.5% for over a decade that China policymakers are targeting. Since China has 10x the population of Japan, its emergence to the middle class will have a tremendous impact on the global economy. In most portfolios we have held a small allocation (< 5%) to EM stocks and bonds in their local currencies. The currency effects of the strong dollar in recent months have erased EM bonds' 7%+ local currency returns and halved local currency EM stock returns of 6%.

For almost two years we have replaced passive EM index positions with actively managed EM funds. Indices are mostly market cap weighted, so EM indexes hold huge positions in BRIC countries. Our active fund choices significantly outperformed passive indices, when BRIC countries struggle. Active international and EM managers can eliminate currency exposure and sidestep troubled countries predominant in passive indices. Lately these fund managers have been reducing exposure to commodity-based economies such as Russia, Brazil and Indonesia and increasing exposure to economies that manufacture finished goods and offshore services (China, Korea, and Mexico). We moved to active international funds to minimize certain European exposures five years ago for the same reasons. We anticipate adding some U.S. dollar denominated international and EM exposure to the mix while the dollar maintains its strength.

Strong dollar environments correspond to weaker commodity (oil, metals) prices and returns. We have maintained a small gold position (< 2%) in most portfolios, which provides an inflation hedge over longer-term holding periods. Gold also acts as insurance in large market sell-offs, such as the 300+ point decline in the Dow on October 9 and outperforms in inflationary environments. As Central Bankers continue to print record amounts of money, the probability of an inflation spike is high. In the near-term though, we will reduce gold-related positions in portfolios. As Europe recovers, the Euro strengthens and inflation rises, we will add gold back to portfolios. In the meantime, we will reallocate these dollars to U.S. equity, which once again looks like the cleanest dirty shirt in the global investment hamper.

Our strong dollar playbook also highlights certain sectors of the stock market. Consumer staples, healthcare, utility and telecom stocks perform well, when the U.S. dollar strengthens. We will likely take profits in energy, materials, industrial and information technology stocks, which perform poorly in strong dollar environments.

The market has dropped 4% since late September. Are we in for a big correction?

Short Answer: We believe the market is fairly valued, but not overvalued. Central Bank interventions and more importantly, corporate earnings, are likely to keep the market in a +/-10% return range. As of October 10, the S&P 500 is off roughly 4%-5% from September levels and could fall another 4%-5%. The market has been choppy and volatile. As the prior section detailed, we believe Eurozone weakness and a strong dollar are the primary reason for volatility. Military escalation against ISIS, mid-term elections and concerns over the Ebola virus have added to investor anxiety.

We are watching market sentiment carefully. We are buying quality, undervalued stocks on these dips. If we see the S&P 500 break through the 1900 level, we will likely pause until the market stabilizes. Until such a breakdown occurs though, we will continue to buy on market dips. Nevertheless, these are tactical trades designed to add incremental value. Generally, we remain bullish on the U.S. stock market. Global market conditions look similar to the latter half of the 1990s, when the U.S. economy was recovering, the dollar was rising out of sync with other currencies, and a technology capital spending boom propelled the market into the new millennium. Furthermore, countries, companies and individuals are paying down debt. Therefore the current environment of deleveraging should place market returns in a more normal historical range than the late 1990s.

- **Market Multiple:** The forward market multiple of 15.2x is in line with 25 year market averages. At the 1950 level, the S&P 500 looks fairly valued, not over-valued, relative to historic levels. Historically, markets have stayed fully valued or at above-average valuations for as long as 10 years.

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- **Multiple Expansion Potential:** Even though the market is close to fair value, we believe conditions are right for the market to continue appreciating. In addition, it is possible that a flow of funds from Europe, Japan and EM countries could chase the U.S. market higher, since the U.S. has a relatively better economic outlook and the dollar remains strong.
- **Market Value Range:** From a valuation perspective, little has changed since July. Applying recent multiples and current earnings estimates implies a range of +/- 10% for the S&P 500. Even though we are currently experiencing market weakness, we believe there is a bias to the upside for the market as long as monetary policy in the U.S and the E.U. remains accommodative and economic activity improves.

Implied S&P 500 Valuation

	$120	$125	$130	$135
14.0x	1,680	1,750	1,820	1,890
14.5x	1,740	1,813	1,885	1,958
15.0x	1,800	1,875	1,950	2,025
15.5x	1,860	1,938	2,015	2,093
16.0x	1,920	2,000	2,080	2,160
16.5x	1,980	2,063	2,145	2,228

Implied S&P 500 Upside/Downside

	$120	$125	$130	$135
14.0x	-8%	-4%	0%	4%
14.5x	-5%	-1%	3%	7%
15.0x	-1%	3%	7%	11%
15.5x	2%	6%	10%	15%
16.0x	5%	10%	14%	18%
16.5x	8%	13%	18%	22%

Bond yields are at record lows, when can we expect them to go higher?

Short Answer: Yields will not likely return to their normal levels for several years, but should increase over time.

- The Federal Reserve is nearing the end of its third round of quantitative easing (QE) announced in Sept. 2012 as it tapered asset purchases at both FOMC meetings again this quarter. The Fed's balance sheet grew by roughly $1.5 trillion during this period. To reduce market volatility, the Fed disclosed plans to normalize the balance sheet at the end of its September meeting. While it may not print money to purchase securities, Fed Chair Yellen said "it would take until the end of the decade to achieve" normal balance sheet levels. Committee guidance on the funds rate for 2015 is mostly in the range of 1%-2%, while the futures market suggests rates will be lower for longer. Dr. Yellen's comments imply it may be over five years before we see normal yields.
- With the increased inter-connectivity of markets, the actions of central bankers in the U.S., Europe, Japan and China are impacting rates outside of their home countries. The law of supply and demand suggest that it will be difficult for the U.S to raise rates as global investors will likely buy U.S. Bonds as opposed to European or Japanese bonds with lower rates that are artificially depressed by monetary actions. Why would an investor want to buy a 10-year Irish or Spanish bond yielding 1.60% or 2.09%, respectively, when they can buy U.S. Treasury bond at 2.33%?

Nation	10 Year Yield	YoY Yield Change
Germany	0.91%	-90 bps
Netherlands	1.05%	-114 bps
Austria	1.11%	-108 bps
Belgium	1.18%	-139 bps
France	1.26%	-108 bps
Spain	2.09%	-220 bps
Ireland	1.60%	-205 bps
Italy	2.33%	-201 bps
Japan	0.49%	-15 bps
Hong Kong	1.81%	-20 bps
United States	2.33%	-33 bps

Source: Bloomberg as of 10/8/14

[1] *Strategy Outlook Fourth Quarter 2014, BCA Research, October 3, 2014, p. 9.*
[2] *IBID, p. 5.*