The View From Catawba

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Benchmark Returns (In Percent)

	2nd Q	Last 12 Months	Last 5 Years (annualized)
S&P 500 Index	5.2	24.6	18.8
Bar Cap U.S. Gov/Credit Intermediate Index	1.2	2.9	4.1
Bar Cap 5 yr. Muni Index	1.3	4.1	4.1
Balanced Return 50% S&P 500 50% BarCap Inter.	3.2	13.8	11.5

UNKNOWN PATHS

Central bank policies throughout the world are now traveling unknown paths. Central bank policies have traditionally addressed business cycle issues. They have been of a tactical nature, designed to nurture an economy that was essentially productive and intact. In the last five years the Fed has pumped four trillion dollars of stimulus into the economy. This massive, unprecedented effort to jumpstart economic growth with monetary stimulus has met with a halfhearted response because the problems in our economy are not cyclical, they are structural. The initial "greens shoots" growth response to GDP peaked at 4% during the 4th quarter of 2009. Despite ever increasing monetary stimulus, growth has been lackluster ever since. The Fed's pervasive, ongoing stimulus program has brought about a very tepid reaction relative to the resources expended. It is small consolation that our Federal Reserve has not been singled out in this regard. In fact, most global central banks have experienced worst results. Regardless of outcomes to date, global central banks are committed to their current paths. They will continue to print money and suppress interest rates.

Traditional and innovative Keynesian strategies for spurring economic growth have met with limited success during the current economic cycle. Cheap, readily available credit has been a formula for economic growth since the Greenspan era, but such tactics have been less effective during the current cycle, despite trillions in stimulus. Since our economic problems are of a structural nature they are much more difficult to remedy. As such, the timeframe for addressing the issues will be prolonged and the desired results slow to develop. In the interim, the central banks of the world will continue their current tact. They will persist in their efforts to jumpstart economic growth through monetary stimulus. Furthermore, central bank schemes to spur economic growth will be increasingly non-traditional, even experimental in nature. Central bankers will never become quiescent and even though they have entered unfamiliar terrain, they will persist in their efforts to revive economic growth. They will continue down their current path as they know no other way.

The world has still not transitioned to a new state of economic equilibrium. Our "new normal" financial world is adapting to secular change which is always a disconcerting process. There are many unknowns in the evolving financial dynamic. What we know for sure is that the central bankers of the world are on a journey from the old to the new without a compass. They are clearly not omniscient and their tactics have proven ineffectual in what appears to be a new global economic reality. Central bankers of the world have been at war with an unprecedented economic slowdown. They will not admit to the existence of what a former Secretary of Defense referred to as "unknown unknowns". Clearly there are things they "don't know they don't know." What we do know is that since 2008 the Fed has printed trillions in new money without creating a comparable amount of economic growth. The only remedy they know is to pump money into the system in the hopes of creating another virtuous

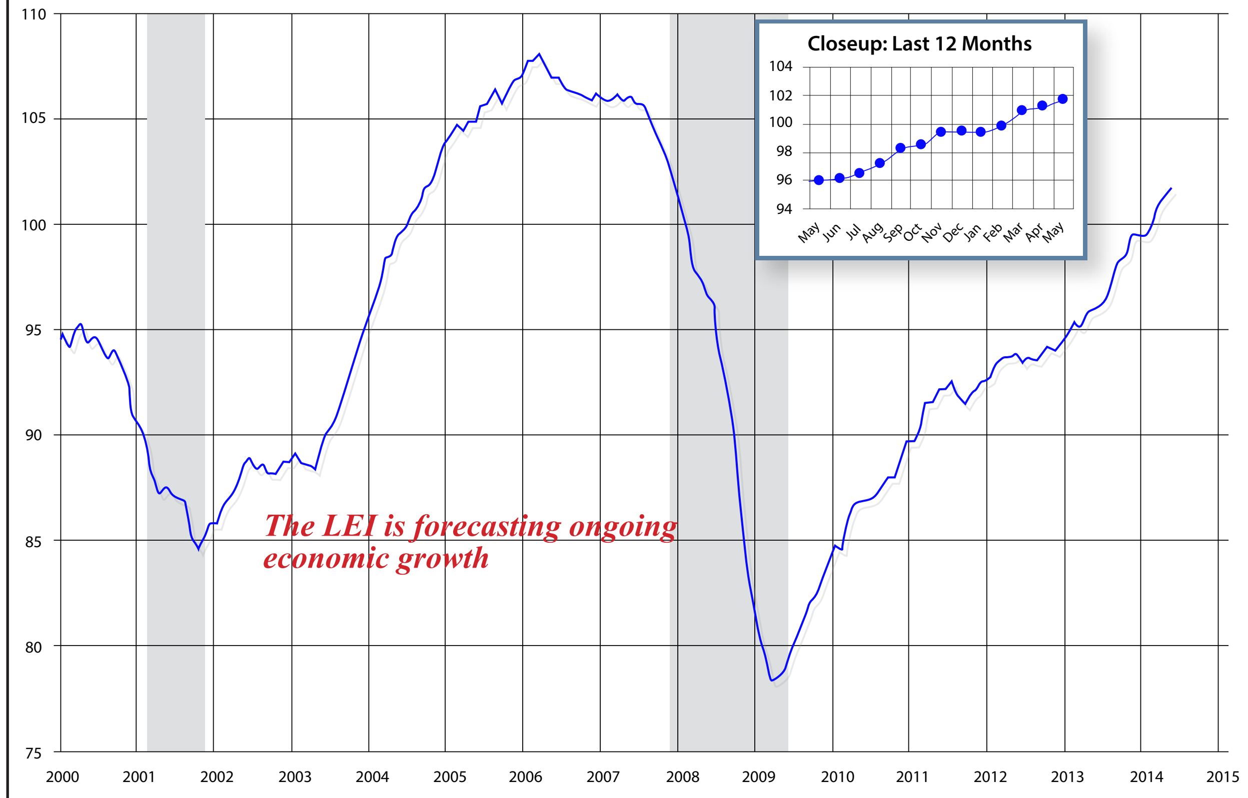
economic cycle. The other fact which central bankers know with certainty is that deflation is the enemy. Whereas inflation reduces the real value of government debt, deflation makes that debt even more onerous. Thankfully their policies have produced a measure of inflation, but in the process they have driven our debt to GDP ratio ever higher. This reinforces their need to keep rates low. They must continue to suppress rates and print money in order to avoid deflationary consequence.

Although we associate depression with outright economic collapse, Keynes defined a depression as "a chronic condition of subnormal activity for a considerable period without any marked tendency toward recovery or complete collapse." Based on that definition our current situation seems to qualify. Keynes would have inferred that the current problems are not cyclical, but rather structural. Our onerous debt burden, fiscal problems, and demographic realities will endure for years to come. Until these underlying problems are resolved, the best to be hoped for is more of the recent experience. Although the current expansion has lasted for almost six years, making it venerable relative to past cycles, the Fed still has its back. Even though they are currently reducing stimulus through a reduction in their QE program, if lackluster growth follows, so too will renewed stimulus. There is no doubt that the Fed will continue to sustain the economy, inflate the money supply, and support the markets. Global central banks are doing likewise. The more vexing question of how central banks will unwind their unprecedented money printing will play out slowly over time. In the interim, rest assured that until money finds its way into the real economy, it will seek refuge in the financial markets.

THE ECONOMY

The current economic expansion has already lasted longer than most postwar recovery cycles, but recession does not seem imminent. Ongoing global bank interventions seem to have rendered boom and bust cycles irrelevant. Given current central bank policies, neither robust growth nor dramatically higher rates are in prospect. Historically, recessions are created by a central bank reigning in robust economic growth with higher rates. This is simply not in the cards. From current artificially low levels rates will inevitably drift higher over time, but vigorous economic growth is not on the horizon, so neither are dramatically higher interest rates. If not induced by higher interest rates, recessions typically have their origin in some sort of external shock such as a potential Ukrainian or Mid East crisis. Such events are by nature unpredictable. Historically the most reliable gauges of future economic direction are the Leading Economic Indicator (LEI) and the yield curve itself. The LEI is forecasting ongoing economic growth, but the yield curve is by no means forecasting a dramatic economic resurgence. The most likely economic forecast is for lackluster economic growth nurtured by an ongoing backdrop of low interest rates.

The current economic backdrop is very different from any encountered in our investing lifetimes. It has progressed in a totally different way and will probably continue to do so. In effect it has been a cycle-less cycle nurtured on the upside by ongoing central bank sustenance. The 2008 Great Recession set the global record in terms of speed and severity of decline. It has been, and will continue to be, a long slow climb toward full recovery. Lackluster economic growth is the most likely as well as the best case scenario. It will be a long uphill battle because consumer indebtedness reached unparalleled heights during the 2000-2007 timeframe. Households have been steadily retrenching ever since, and after six years of fiscal sobriety, considerable progress has been made. U.S. household debt as a percent of disposable income has diminished from over 130% of disposable income to less than 110%. Furthermore, debt service ratios and delinquency ratios are at decade lows. Over a trillion dollars of consumer liabilities have been paid down which should set the stage for better growth patterns in the future. Even so a chastened and aging consumer is likely to be a more responsible one.

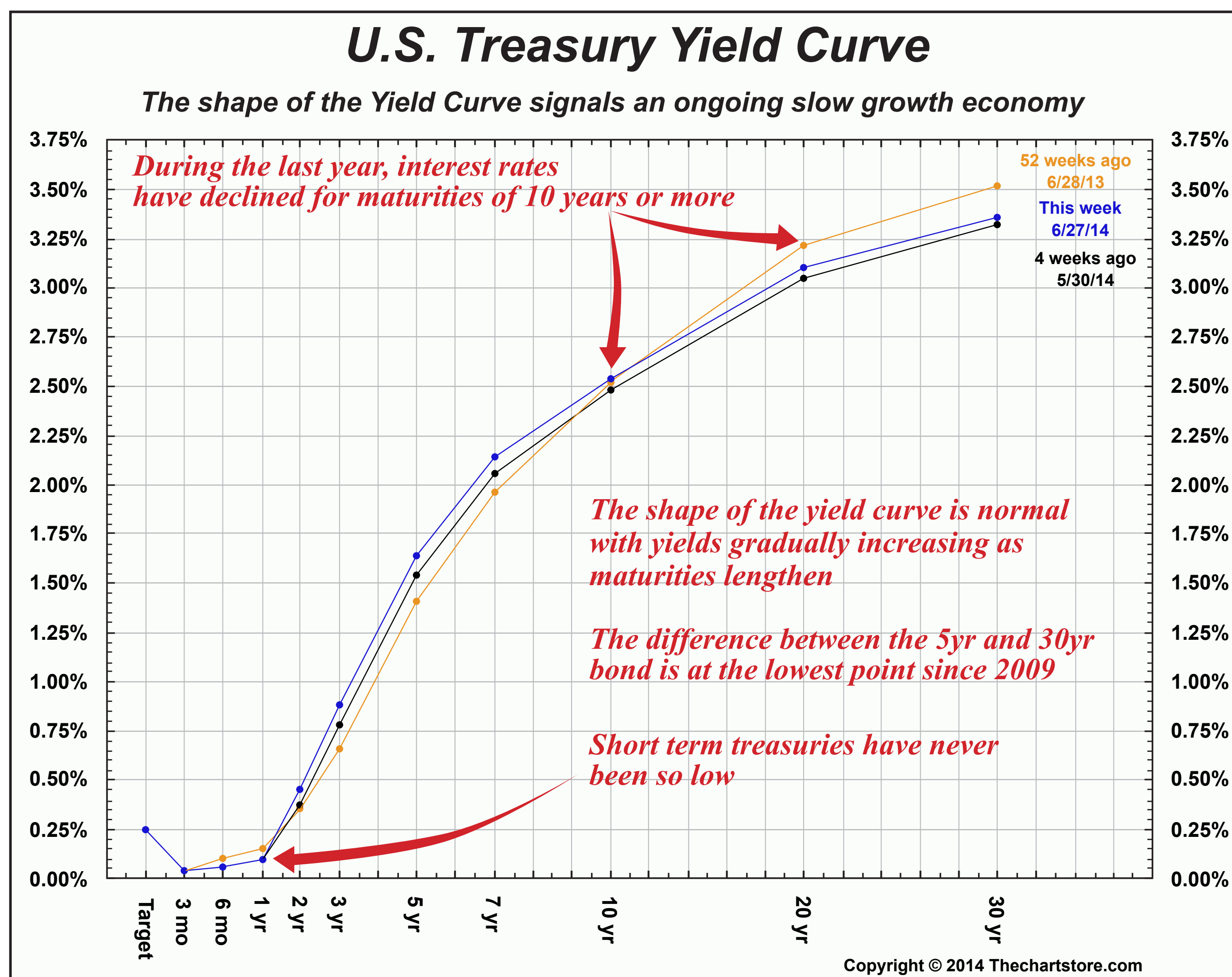


The customary 3- 4% quarterly GDP growth numbers of the past are likely to stay there. Future growth is more apt to be in the 2-3% vicinity. A more subdued GDP growth pattern is also consistent with what economists refer to as the Natural Rate of Income Growth (NRIG). The NRIG is basically a function of the growth of an economy's work force plus a productivity factor. Taken together they approximate the growth of GDP. Currently our labor force is only growing at a 1% rate and our productivity growth factor has diminished to 1.5%. Any incremental growth above and beyond the combination of these two factors must flow from the 30% contribution to GDP made by the corporate sector. Corporate America has weathered the economic storm of recent years in an admirable fashion. Corporate balance sheets have never been better. From current levels, even modest consumer growth should result in capital spending by Corporate America. Capacity utilization is very close to 80% which has typically been a trigger point for corporate investment in plant and equipment. Even modest consumer growth from current levels could trigger capital spending which would create incremental economic growth in excess of the NRIG. In the interim reasonable, albeit subpar, growth seems in prospect and the Fed remains at the ready.

It is important to realize that the current financial dilemma is international in scope. While Federal Reserve policies have proven somewhat disappointing in an absolute sense, relative to other central banks they have been incredibly successful. Our economy is on the mend while many others are only treading water. Surplus foreign funds are also searching for safe and productive depositories. The U.S. still offers the best relative economic circumstance and the dollar remains the global reserve currency. Furthermore, U. S. interest rates, as low as they are, remain quite attractive relative to prevailing international rates. Money will find a depository somewhere and the United States remains the best house in the international neighborhood.

Earlier this year the bond market seemed to be on a path toward higher rates, but it made a dramatic U-turn this quarter. As the year began most institutional investors were positioned for higher yields. The Fed's tapering process had been ongoing for several quarters, and the logical forecast was that rates would rise as rational investors demanded higher yields once the Fed cut back its asset purchasing program. Contrary to consensus opinion, the yield on the bellwether 10-year Treasury note, which ended 2013 at 3.03%, fell as low as 2.44% this quarter, and closed at 2.53% on June 30th. Treasury yields remain low because that's where the Fed wants them to be, but also because economic growth and inflation are low. Rates could even go lower yet because financial markets capital flows are not bound by international borders. Even as the Fed wends down their U.S. treasury purchase program, foreign investors are increasingly routing their funds into U.S. Treasuries. While the Fed is tapering, the world still remains awash in liquidity. Global monies are seeking out U.S. Treasuries on the basis of yield and safety. Uncertainties in the Ukraine and the Middle East lend further impetus toward U.S. Treasuries as foreign funds seek refuge in the dollar.

The yield curve will warn us when a true bond bear market develops. The yield curve depicts the difference between short, intermediate, and long term yields, as illustrated in the nearby chart. It tells us a lot about economic prospects and financial markets. Normally the yield curve displays gradually increasing yields coincident with increasing maturities. Typically, the longer



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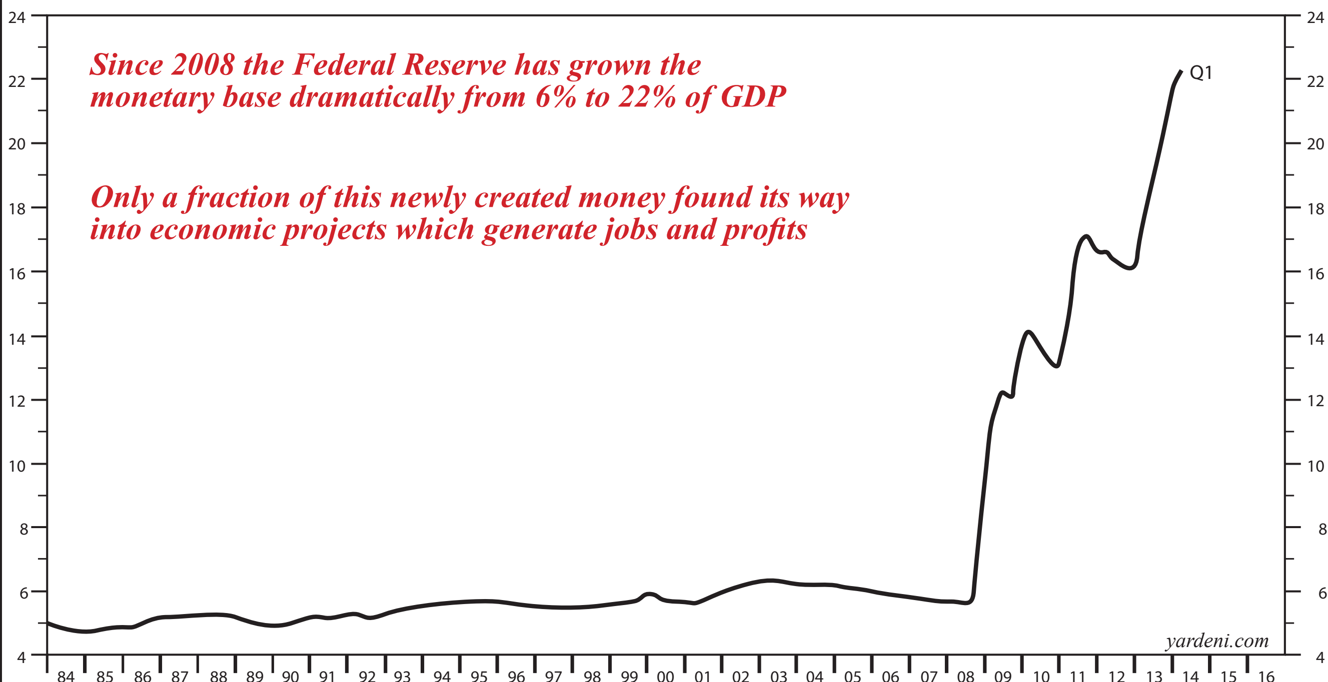
the maturity the higher the yield. Currently the yield curve is modestly sloped, meaning there is not much difference in yield between lengthening maturities. When the difference in yield between short and longer maturities rises, it is known as a steepening curve. This typically reflects strong credit demand and a growing economy. When short rates move higher than long rates, the yield curve is said to be inverted. Yield curve inversions have always been a sign of forthcoming recession. In fact, every recession over the past fifty years has been preceded by a flat or inverted yield curve. Things will probably not be different this time. While this market has been unduly manipulated by government stimulus programs, this tried and true rule should hold. The bond and equity bull markets have room to run as long as an inversion is not in process. Moreover, an inversion occurs when the Fed raises short term rates, which they have repeatedly promised won't happen. This month the yield curve approached its flattest level in five years. It's hard to have a bear market in bonds or stocks without a Fed tightening.

What we know for sure is that the Federal Reserve now owns the lion's share of the U. S. bond market, to include 30% of all 10-year bonds. Even with the tapering the Fed acquires 0.2% more of the U.S. bond market with every passing day! Their balance sheet has grown from $800 billion to $4 trillion in recent years. The Fed will ultimately stop buying bonds, but they will not sell the bonds they have purchased. The Federal Reserve's portfolio will mature over time, but it won't be sold. Permitting rates to rise could result in fiscal disaster. Since 2008 the Federal Reserve's efforts to stimulate economic growth have expanded our economy's monetary base from 6% of GDP to over 22% of GDP today. That money has not found its way into economic endeavors so it continues to reside in the financial markets.

Former Fed Chairman Bernanke is now on the speaking tour commanding $250,000 per engagement. His prediction is that the Fed will raise rates very slowly and do so much later than most forecast. Current Chair Yellen shares this view. This month she reaffirmed that there will be a considerable time before the Federal Reserve raises its benchmark Fed Funds rate. In the interim the financial markets will continue along their recent path.



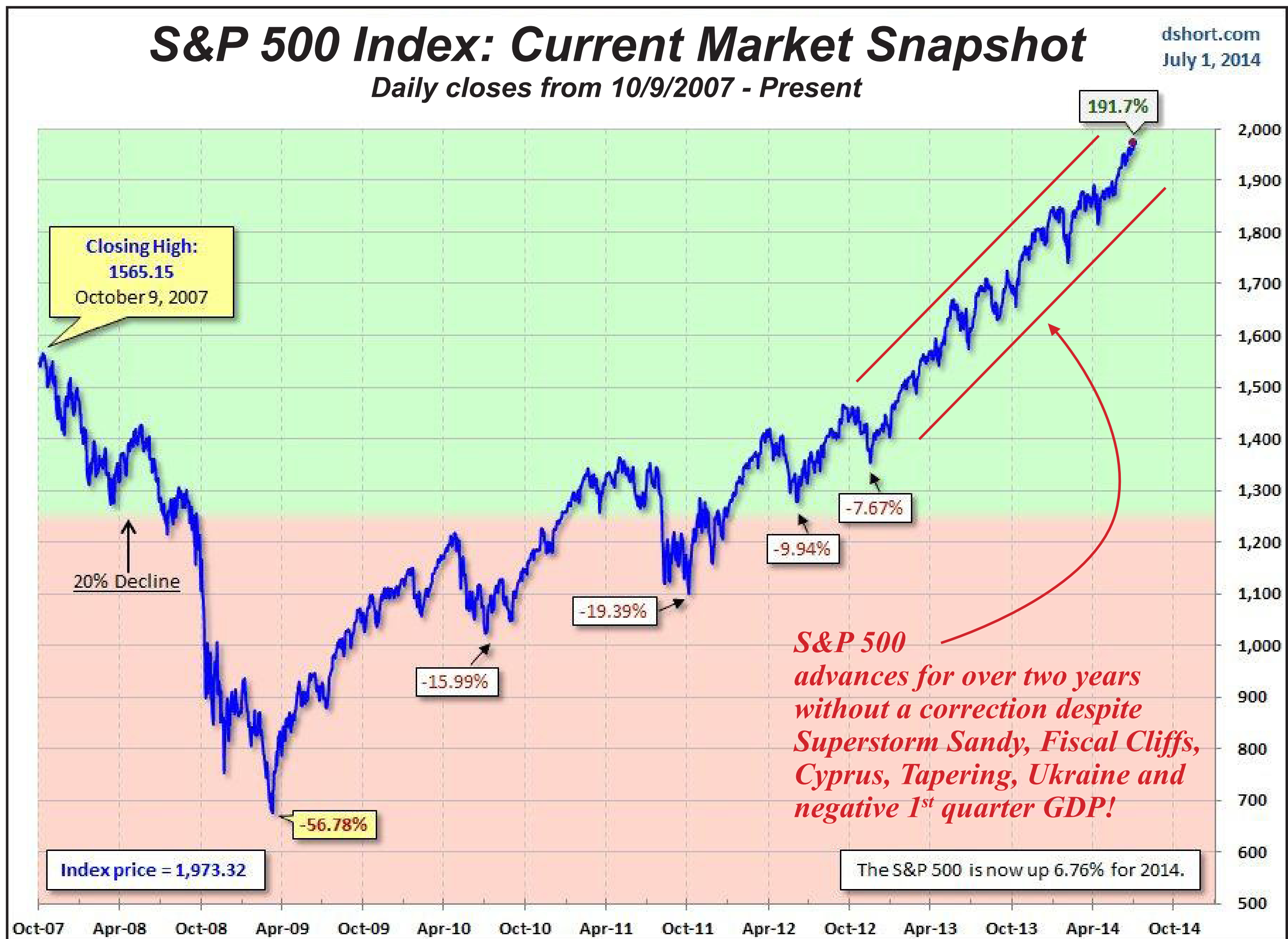
Global financial wealth has doubled since the turn of the century, but it did not double due to ascending stock markets. The increase in global wealth was primarily driven by growth in the global bond markets. Since 2000 the value of debt securities has tripled, whereas over the same period global stock market valuation has increased only 35%. Bonds have grown dramatically as a percent of international capital, whereas stocks now make up a lesser percentage of the overall asset pool. Einstein believed that there was no such thing as an absolute system of reference. He contended that things only moved in relation to one another, not to a fixed set of points. During the last decade central banks have literally changed financial reality. In the process they have transformed the financial landscape and altered tried and true financial guidelines. They have created money at an unbelievable rate and have reset the realities of the financial world. Relative to the size of our economy there has never been a greater quantity of money in circulation. Relative to the economy the U.S monetary base has grown almost 3.7 times during this economic cycle. Unfortunately, only a fraction of this newly created money has found a path to real world economic projects which generate profits and jobs.

Money that does not find its way into the real economy via bank loans must seek out a productive resting place in the financial markets. Ultimately it will settle where it is treated best. Bonds have treated investors incredibly well for over thirty years; stocks have treated investors well for the last five. From here money will seek out the best available risk-adjusted return. In an era of negligible, even negative, inflation adjusted bond returns; investors remain desperate for a reasonable rate of return. In all probability they will continue to decide in favor of equities. Using an absolute frame of reference it is difficult to make the case that stocks are cheap, but neither are they outrageously expensive. Stock analysts are trained to evaluate through an absolute framework utilizing metrics that have worked well over time and through cycles, but the financial world has never experienced the current circumstance. Einstein's theory of relativity might have application in our new financial universe. He believed that an absolute system of reference does not exist. He asserted that things actually move only in relation to each other, not to a fixed set of points. It was his contention that all values are relative. Despite the S&P 500's steady advance in recent years, relative to the prevailing financial alternatives, U. S. stocks offer genuine value. In fact, relative to the vast pool of funds created by the Federal Reserve, stocks appear inexpensive. As a percent of the monetary base the total market capitalization of equities is trading at levels not seen since 1982. Unfortunately, the single digit P/E multiples and 4% dividend yields of that era remain relics of the past.

Whether the theory of relativity is applicable to financial affairs is debatable. However, it is a fact that there is a much greater quantity of money in the world today than existed in 2008. Since that time global central banks have dramatically increased global money supply. When one creates more and more of something it has a tendency to be worth less and less. In a world of superfluous money creation it stands to reason that existing assets will be valued higher relative to a cheapened, debased currency. Global money printing seems to be recalibrating the definition of value. It's not so much that stocks are worth more as it is that global currencies are worth less. Value is being assessed in terms of a new monetary unit that is not worth as much as the old.

This generation of stock analysts has been trained to believe that "it's not different this time." Clearly it is. The world is awash in liquidity. The central banks of the world have changed our financial reality. Stock valuation parameters are not cheap with reference to history, but they are cheap with reference to virtually all alternatives. The absolute metrics of the past may or may not need to be recalibrated to account

for the dramatic increase in global money supply. However, it is a certainty that the central banks of the world will continue to push investors toward stocks. The central banks will continue along their current path; it's all they know. The European Central Bank is on the verge of imposing negative interest rates, U.S. regulators are considering exit fees for bond funds, and global central banks are buying stocks. Valuation does not reign the day. Central banks do. Ultimately, money must find a depository. Central banks of the world have created a circumstance wherein fixed income investors are being penalized by unusually low interest rates. Throughout financial history there has never been a period when capital has had so few choices for a reasonable rate of return.



THE VIEW FROM CATAWBA

- The world seems to be caught in a perpetual liquidity trap wherein ultra-low rates are not creating much in the way of economic growth. Funds that do not find their way into productive economic projects will find a home in the financial markets.

- The world is awash in liquidity and investors are being forced to come to grips with a changed landscape. Concepts of absolute and relative value are changing. Investors must reshape their understanding of cheap and expensive. Unprecedented stimulus by the Fed has rendered many traditional investment models less useful.

- The majority of fixed income investors expected higher rates this year, but the markets generally don't accommodate investor expectations. Halfway through the year the big surprise of 2014 has been the decline in treasury yields.

- It's hard to have a bear market in bonds without a Fed tightening. Most have been triggered by yield curve inversions and that simply isn't in the economic cards. The Fed is under no pressure to raise short rates.

- The low interest environment may persist for years. Higher fixed income yields will be hard to come by. The Fed is confronted by obstinate structural issues, to include demographics and high debt levels. The current economic malaise may persist despite their ongoing support.

- The rumors of the bond market's death were greatly exaggerated. The reality of low yields will probably persist. There is simply too much slack in the economy to support a substantial rise in rates. Low real rates may be the norm for some time to come.

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