September 30, 2015

The View From Catawba

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Benchmark Returns (In Percent)

	3rd Q	Last 12 Months	Last 5 Years (annualized)
S&P 500 Index	-6.4	-0.6	13.3
Bar Cap U.S. Gov/Credit Intermediate Index	1.0	2.7	2.4
Bar Cap 5 yr. Muni Index	1.2	1.9	2.8
Balanced Return 50% S&P 500 50% BarCap Inter.	-2.8	1.2	7.9

THE END OF NORMAL

In recent years the financial community seems captivated with the idea of normal. It longs for the halcyon days of old when markets were normal and understandable. The financial world has endured incredible change during the current cycle. In recent years we have survived the New Normal, Quantitative Easing, and ZIRP (zero interest rate policy) programs and more innovation is surely in our future. Recently a noted economist, James Galbraith, pontificated in The End of Normal, that investors need to realize that normality is not constant. It is something we adapt toward. He asserts that the 70's ended the age of easy growth. He makes the case that economic growth has been increasingly more difficult to come by despite the evermore creative efforts of monetary policy. He further asserts that the Federal Reserve will probably not succeed in their efforts to bring back high growth and full employment.

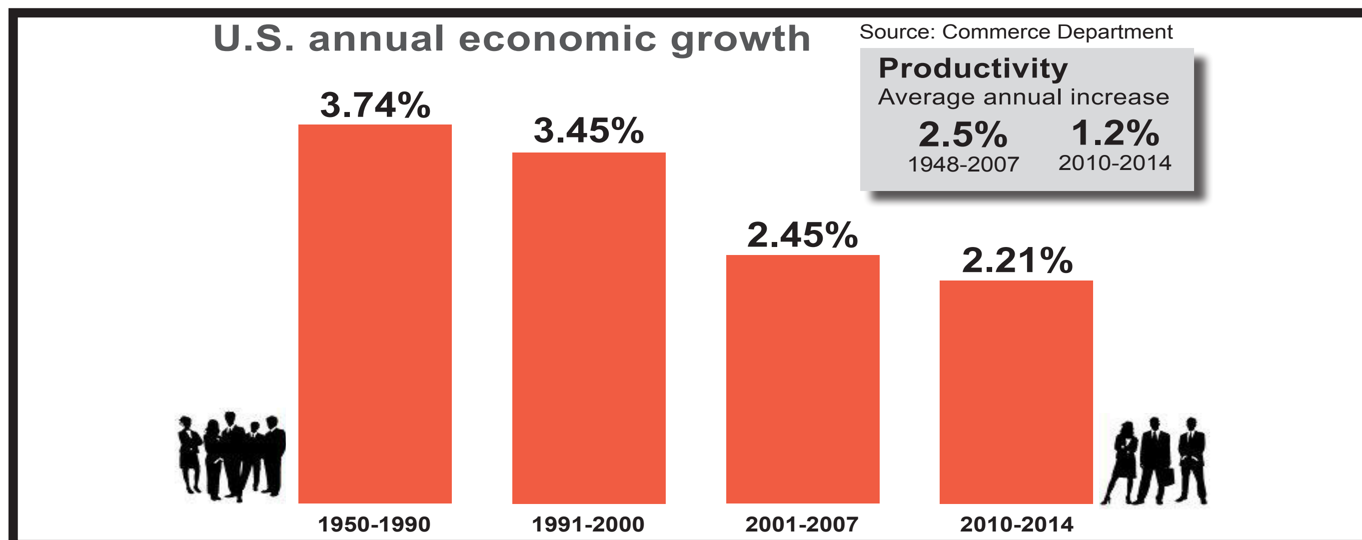
Normality is a concept in perpetual transition. Most economists assume that future economic growth should echo the patterns experienced during the last 65 years, less the period of inflation realized during the late 1970's. Mainstream economic theory contends that the 2008 crisis was an anomaly, a temporary interruption to be followed by a return to normal. Normal is not something we return to, it is not an absolute concept. It is a relative concept and it is ever changing. Economists longing for the good old days characterized by strong economic growth and wide ranging interest rate fluctuations will be disappointed, but investors will be rewarded nonetheless.

Our current economic/financial reality is that we will live in the shadow of the 2008 economic crisis for years. The essence of the problem was inordinate debt and the problem was addressed through the creation of even more debt. That is our new reality. Change is the one constant in life and in financial systems. There is no doubt that the economic/financial world has been transformed and investment perspectives must change accordingly. Dynamic economic growth is no longer normal, nor is it continuous. Stock values aren't characterized by single digit price/earnings multiples anymore, nor are bond values characterized by high yields. Even so, our current condition is normal relative to our changed circumstance.

Economic growth and investment returns are not correlated in a homogeneous way over time. Growth is a natural state, but it is not a steady state dynamic. The strength and duration of economic expansions have always been subject to change, as have the risk and rewards of the financial markets. More so than at any time in the past, economies and financial markets are now subject to the ongoing influence of central banks. They have changed the very character of the financial markets. The most potent financial force in history is currently wielded by a confederation

of central banks that is determined to sustain economic equilibrium. In order to do so they must sustain the financial markets as well.

Since 2008 the American economy has performed well relative to the rest of the world. Our last quarterly GDP number was a strong 3.7% whereas European growth is barely positive and many emerging economies are posting negative growth. Our economy's strong relative performance will persist, even if its absolute performance withers somewhat. In spite of zero interest rates and quantitative easing, U.S. economic growth has been lackluster, yet our markets continue to advance. GDP growth was recently revised down for 2012 and 2013, but the financial markets didn't flinch. General economic conditions are no longer the almighty determinant of investment outcomes. Economic and financial linkages change. In fact, economic statistics have only a weak correlation to investment returns. This has especially been the case during the current cycle which is in its 74th month. Slow and steady wins the race and continued expansion seems in prospect.

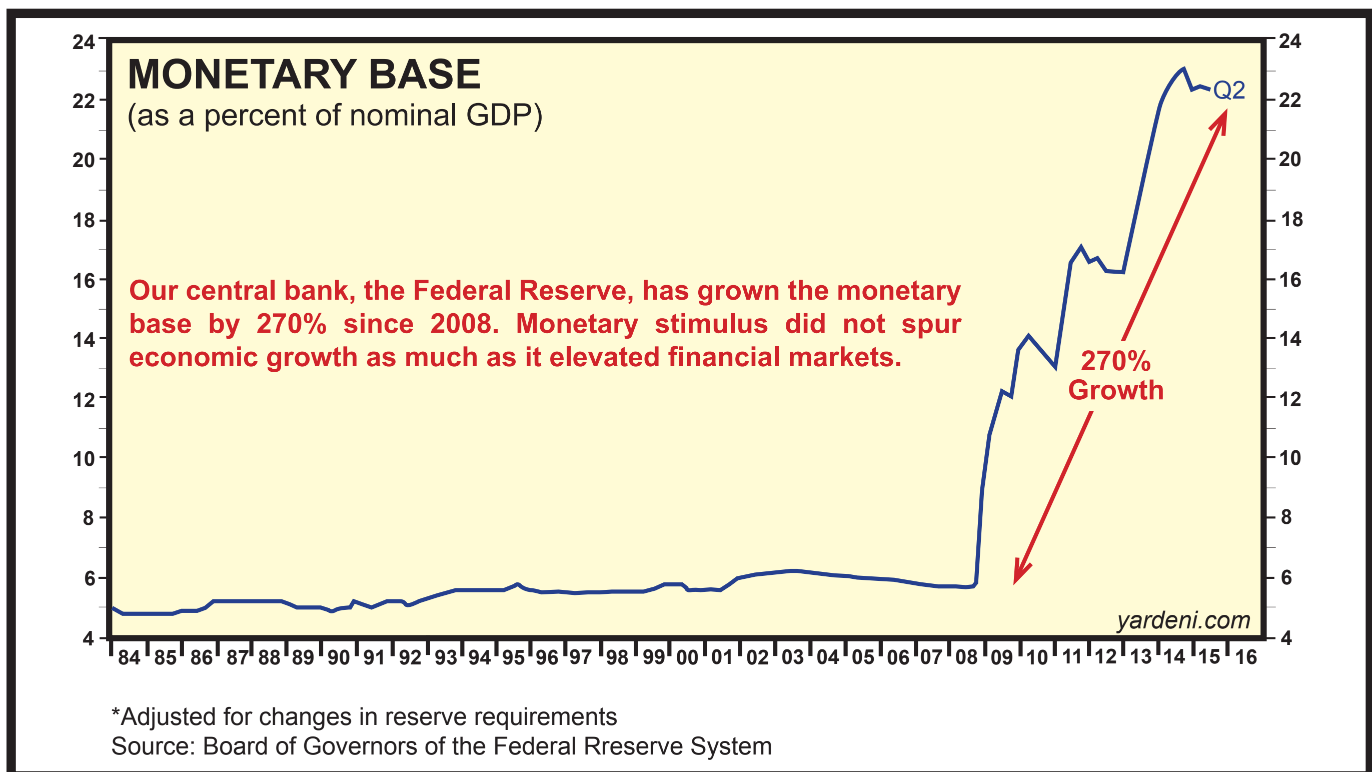


While the economy has grown at a comparatively weak pace since 2009, the markets have moved to all-time highs. Given the longevity of the current expansion, it seems logical that the stress necessary to cause a recession and/or financial crisis would be diminished. Central bankers are acutely aware of this fact. Higher interest rates would be conducive to economic weakness, which is why higher rates are not in prospect. Historically, most recessions have been purposely created by the Federal Reserve elevating short-term rates. Given the current fragility of the international economy, the Fed is not willing to jeopardize global growth. Our penance for the ongoing creation of new money will be a long, drawn-out period of low interest rates and subdued economic growth. While the current economic circumstance is disappointing relative to the extent of global central bank stimulus, it has been and in all probability will continue to be, advantageous to financial markets. Money stimulus has not spurred economic growth; instead it has elevated financial markets. Odds favor a continuation of that circumstance. Central bank stimulus will remain at the core of our current economic reality and it will continue to manifest in the

form of elevated financial markets.

What's normal is in constant flux, and so too are the valuation parameters of the financial markets. As the chart of U. S. annual economic growth illustrates, the U. S. economic growth pattern has slowed over the course of our lifetimes, yet the markets have fared well. Slowing economic growth does not impact the markets to the degree it has historically. Central banks have taken center stage. In the Central Bank Era the higher correlation seems to be with the growth of money. The inflation that matters to the financial markets is not the traditional notion as defined through a derivative of the CPI, the PCE, or the PPI. The inflation that matters is the inflation of the money supply which continues to grow at over 8%. When money supply grows faster than the real economy's ability to absorb it, money finds its way into the financial markets. Global central banks continue to create new money and those funds must manifest either in the form of economic growth or higher markets.

The Greek philosopher Heraclitus asserted that "*The only thing that is constant is change*." That seems to be especially true for the financial markets. During the recent market cycle the correlation between economic growth and stock prices has diminished while the link between money growth and stock market appreciation has been enhanced. Since 2008, $60 trillion of new money has been created by the central banks of the world. Over the same time frame U.S. money supply has grown 270%, while our economy has only grown by 14%. Over the last six years, the S&P 500 has risen seven times faster than GDP growth. It's a given that money which does not find its way into the economy must be deployed into the financial markets. Progress in the financial markets has become more highly correlated with the unprecedented growth in money supply.



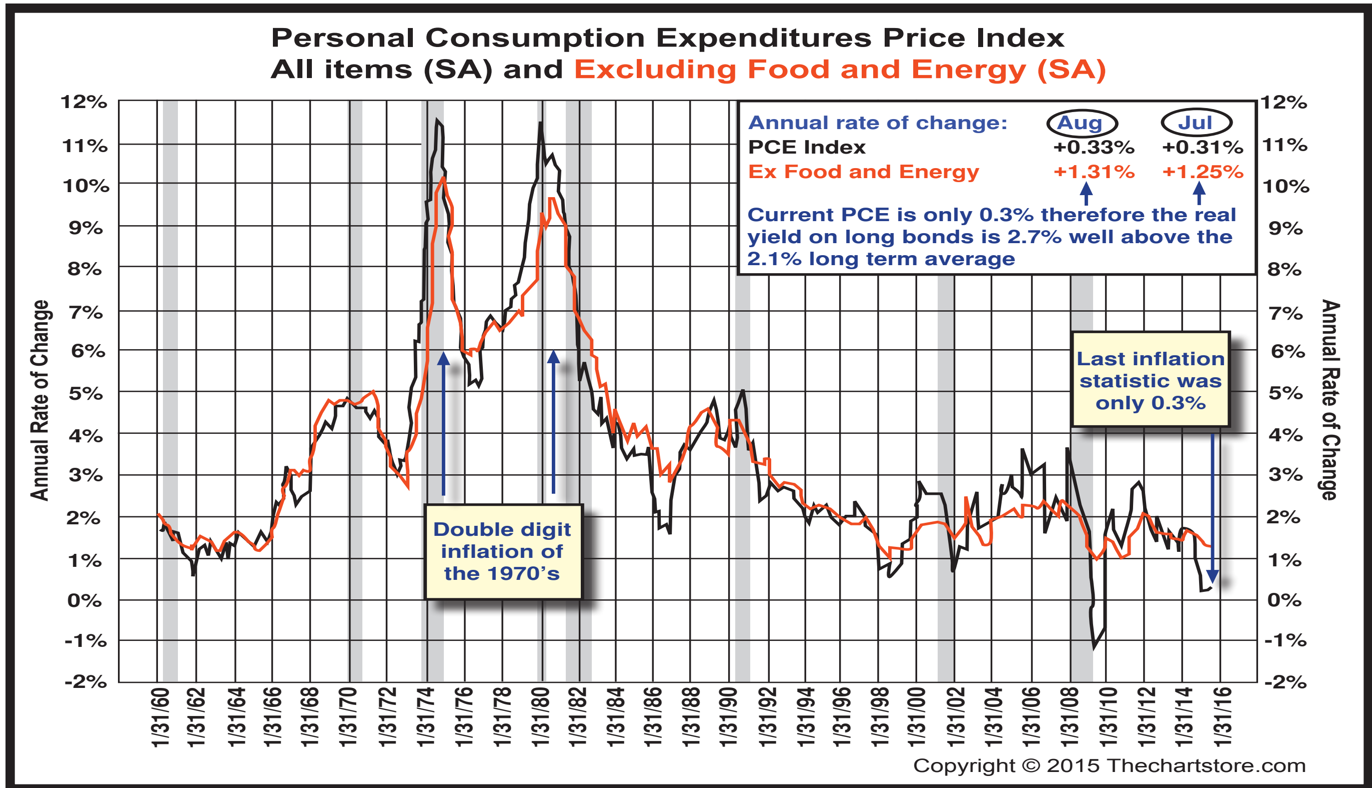
*Adjusted for changes in reserve requirements
Source: Board of Governors of the Federal Rreserve System

BONDS

The essential ingredients for higher bond yields are missing. Yields rise in the midst of strong economic growth which fosters robust credit demand and rising prices. These factors are simply not evident in the current economic environment. Furthermore, existing debt loads remain high and price levels are generally flat to down. As long as these conditions persist interest rates will remain low. On the supply side of the equation inventories are abundant and on the demand side matters remain uninspiring. Both phenomena tend to subdue interest rates. Prices are low throughout the commodity complex suggesting that a disinflationary scenario is possibly in play. As long as this backdrop persists probabilities suggest that interest rates will remain low. The current deflationary backdrop should anchor rates around current levels. Most economic and financial conditions point toward a persistence of low interest rates. The Federal Reserve has been threatening higher rates, but our domestic economy simply can't muster the strength to surpass the Fed's own self-imposed criteria for higher rates. Furthermore, as amazing as it may seem, our rates remain high relative to the rest of the world.

Given the current investment setting U. S. investor fears of higher rates seem premature. This is all the more true when an investor considers the plight of the international economy. While the U. S. economy's growth trend remains intact, the global economy continues to struggle. Economic strength is necessary to drive international rates higher and recent data points to weakness, not strength. U.S. Treasury rates are high in comparison to our major trading partners. The 10 year Treasury trades at 2.05%, a substantial premium to the comparable German Bund which yields only 0.7 %. The current character of the international markets supports and reinforces the attractiveness of U.S. bonds. Additionally, the strength and stability of the dollar will continue to attract foreign investment flows to U.S. Treasuries. The case for higher rates in the U. S. is substantially diminished by the disinflationary character of the commodity markets and by the persistent strength of the U.S. dollar. Global Investors will continue to favor the safe haven of Treasuries.

Considering the longevity and relentless move toward ever-lower rates, some fixed income pundits are referring to the current long-lived bond bull market as a bubble. The fact of the matter is that investment bubbles are a function of behavioral psychology. They are characterized by easy money, rising prices, the herd instinct, and the notion of greater fools. At the essence of a bubble is the idea that more and more investors pile into sercurities driving them toward evermore irrational heights. Analytics always take a back seat when bubble psychologies prevail, but analytics continue to support bonds in the current context. The current bond condition is a function of present day realities. Investor attitudes are colored by their personal experiences and few current day portfolio managers were around in the 1970's. To defeat the damaging inflation of the 70's era, Chairman Volker took short term rates to 20% and broke the back of inflation in the process. Rates have moved ever lower since, and bond prices have consequently moved ever higher. The long bond yielded 18% in 1979, as opposed to its present day yield of less than 3%, but yield attractiveness can only be measured in relation to inflation. The 18% yield in 1979 was underpinned by a double digit inflation backdrop. Current day inflation is only one tenth of the 1979 level. Yields must be viewed in the context of today's realities. From an investment management perspective, nominal yields must be inflation adjusted to provide true analytical insight.



Our perspectives are mostly shaped by our recent realities so a little historical perspective is appropriate. Over the past 145 years the real yield on the 30 year Treasury Bond has averaged 2.1%. The current nominal yield is 3.0%, before inflation adjustment. Adjusted for inflation which, as measured by the Personal Consumption Expenditures Index was only 0.3%, the current real yield is 2.7%. This is well above the historical long-term real yield average of 2.1%. Even after adjusting for the disinflation experienced in the food and energy components, core inflation was only up 1.3% year over year. Either measurement disproves the bond bubble thesis. Both imply continued appreciation potential in U.S. Treasuries. Based on current realities the bond market offers up little in the way of an absolute coupon return, but the real yields are consistent with historical experience. Despite the diminutive numbers, prevailing real yields are reasonable. In fact, relative to the longer term perspective, one can make the case for continued downward bias in long-term yields which implies even higher bond prices. Despite historically low nominal yields, bonds still offer a reasonable inflation adjusted real yield. The current bond market is not in a bubble.

STOCKS

Fundamental analysis refers to a methodology for evaluating securities that measures a company's worth or intrinsic value by objectively examining virtually everything that might affect a security's price. The ultimate goal of fundamental analysis is to compare a security's current worth relative to its prevailing market price. The process includes studying the overall economy, industry conditions, as well as company-specific factors. There are a myriad of factors that affect securities pricing, foremost of

which are revenues, earnings, return on equity, and profit margins. Currently, stocks are not dramatically overpriced, but they are not cheap based on 2015 earnings. The outlook for stocks increasingly depends on 2016 earnings, and if current forecasts prove somewhat accurate, stocks should continue to advance. If there is a chink in the S&P 500 armor it has to do with foreign sales. While the U. S. economy continues to plough forward, our global trading partners remain mired in a slowdown and international revenues represent 47% of S&P 500 sales. To make things all the more difficult a 17% increase in the dollar during last year makes U.S. products more expensive abroad. Revenue growth is the principle driver of equity valuations and it will be more difficult to attain in 2016.

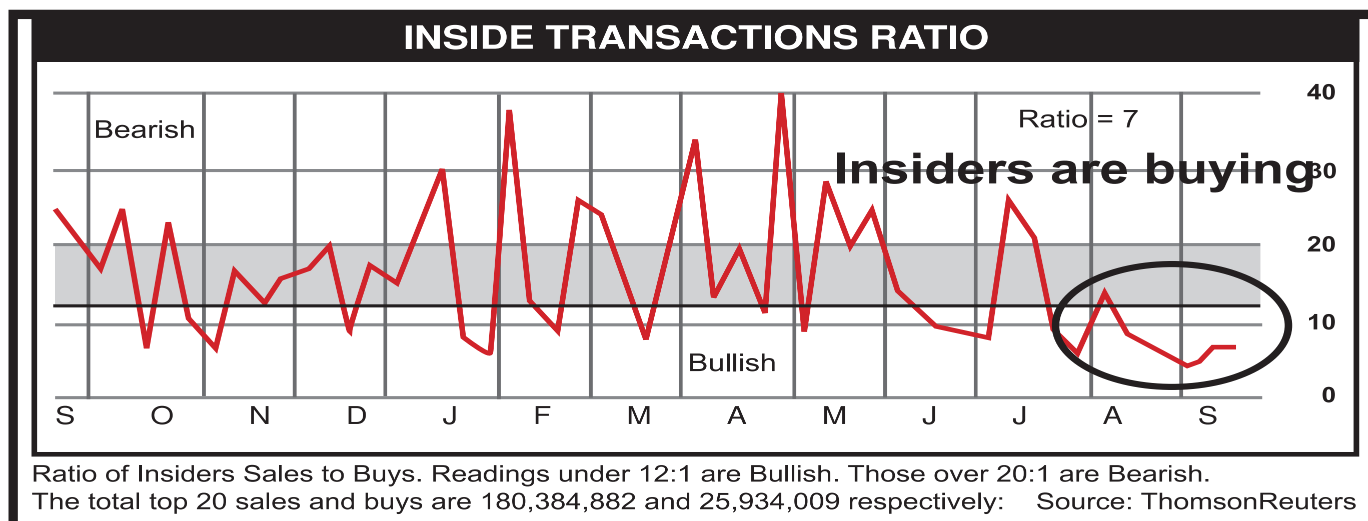
Valuations are the fundamental driver of long-term investment returns, but returns over shorter time frames are driven by investor attitudes. Currently, investor sentiment seems to be playing a more important role in determining stock prices. In fact, valuation measures of the past have proven less effective in recent years and may remain less germane in the current environment. Tried and true fundamental valuation metrics are no longer the all determining factor of stock prices. Valuation remains the most important predictor of long term returns; but, in the short term, investor psychology is quite influential. Investor psychology seems to be taking on greater import in the current environment. It is important to keep in mind that a 10% correction is not a crash, but in fact is quite normal. It just feels abnormal because investors have not experienced volatility for a long while. The recent market correction is in fact a routine phenomenon. Volatility and market downdrafts are natural. September is historically the worst month of the year and it is now in our rear view mirror. In the midst of the current more volatile market, it's important to keep in mind that your investment portfolio is designed to carry you through decades. Bad days, months and even quarters are part of the process.

Markets rise and fall further and faster than logic would dictate due to psychological forces. Fear and greed frequently overwhelm logic and analysis and there currently seems to be an abundance of the former. Certainly there are a lot of headline concerns; commodities have plummeted, China has fallen, Europe remains on the ropes. As indicated by the above magazine cover, a negative psychology currently seems to have the upper hand, but the S&P 500 has not violated its bullish trajectory. Furthermore, technical declines in price have invariably been met by Federal Reserve assurances. Long-term investors need to eliminate the idea of bullish or bearish, of fear and greed. Rather, they should focus on the risk inherent to their specific portfolio. The important thing is to stay focused on the long term. Recent volatility raises concern and angst in the markets, but the reality is that market corrections represent the proverbial pause that refreshes. This market was due for a breather. This quarter marked the longest period it has taken the S&P 500 to correct 5%

since WWII. On average 10% declines occur every 18 months and this market didn't correct 10% for almost 4 years.

Most of the stock indices are negative through the end of the quarter, but the year is not over yet. A down year in 2015 would be the first time since 1945 that the third year of a presidential cycle posted a negative return. It would also be the first time since 1905 that a year ending in 5 posted a negative return. During the current bull market investors have been spoiled by a steady, uninterrupted rise. Since 1900 declines of 5% happened three times a year and declines of 10% once a year. Investors need to remember that corrections are in the nature of the market. They should also be aware that durable lows are characterized by a significant increase in the number of bears. That has already happened in the Investor Intelligence Polls which are registering the greatest number of bears in some time. Investor psychology typically creates a market bottom coincident with the famed Magazine Indicator. This contrarian indicator usually occurs when a trend is reaching climax and on the verge of reversal. Judging from the recent cover of Bloomberg Businessweek, the bottom is in. Contrarian analysis suggests that pessimism is a bullish sign. As Warren Buffet puts it, *"Be fearful when others are greedy and greedy when others are fearful."*

The one constant in life and in the financial markets is change and that includes change in valuation scales. Fundamental analysis and traditional valuation metrics are adapting to new dynamics imposed by central banks. A dollar of earnings was worth more during the late 90's than it was during the stagflation of the 70's. A lower multiple is appropriate during high inflation and high unemployment. A higher multiple is in order when the opposite circumstances prevail. The seemingly high valuation multiple assigned to stocks today is justified by the current circumstance of low inflation, low unemployment, and low interest rates. Times change and so do relative values. Valuation metrics must be adjusted relative to dramatic change in the financial and economic backdrop. It's not all about the economy. Recently, the Federal Reserve made a dramatic downward adjustment to their economic statistics. That adjustment lowered the previous assessment of economic growth over the past 4 years by 12%, but the market didn't respond. It had already discounted that reality. The Fed is not omniscient. In fact, insights on the stock market are best given by those who take their cue from the fundamentals. The Insider Transaction Ratio tracks the stock transactions of corporate officers who know the fundamentals best. Insiders are buying.



Ratio of Insiders Sales to Buys. Readings under 12:1 are Bullish. Those over 20:1 are Bearish.
The total top 20 sales and buys are 180,384,882 and 25,934,009 respectively: Source: ThomsonReuters

VIEW FROM CATAWBA

- The stock market's advance has become more highly correlated to the growth of global money supply. Since 2008, $60 trillion worth of new money has been created by central banks while global GDP has grown by only $12 trillion. The excess must be invested.

- In the midst of the current more volatile market, it's important to keep in mind that your investment portfolio is designed to carry you through decades. September is historically the worst month of the year and it is now in the rear view mirror.

- What's normal is in constant flux, as are the valuation parameters of the financial markets. The U.S. economic growth pattern has slowed over the course of our lifetimes, yet the markets have fared well. Our markets are attractive relative to the rest of the world.

- In the current economic setting the Fed's pre-announced employment and inflation targets will be attained later than normal, perhaps much later. This will keep rates lower for longer.

- The essential ingredients for higher bond yields are missing. Yields rise in the midst of strong economic growth which fosters robust credit demand and rising prices. These factors are simply not evident in the current economic environment.

- Contrarian analysis suggests that pessimism is a bullish sign. As Warren Buffet puts it "*Be fearful when others are greedy and greedy when others are fearful.*" S&P 500 stocks are reasonably valued based on current earnings forecasts.

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