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QUARTERLY COMMENTARY

April 6, 2015

March marked the sixth anniversary of the Fed–sponsored stock market rally that, along with the housing recovery, has resuscitated the balance sheets of the wealthiest segment of the American population. Having benefited from mountains of essentially free money and generous accounting forbearance, the nation's major banks were rescued from insolvency. The Fed's intended "wealth effect" has served the wealthy well. Unfortunately, it has done relatively little for the vast majority of Americans, who continue to struggle in the slowest economic recovery in three-quarters of a century. As the latest iteration of money printing winds down, the dominant question is whether or not stock and bond markets can continue to progress without the benefit of unprecedented Fed stimulus.

Both domestically and internationally, central bank largesse has overcome a litany of geopolitical and economic concerns including: Greek solvency and Eurozone membership, Russia/Ukraine and sanctions, Israel/Gaza, ISIL, Ebola, the end of Quantitative Easing and the prospect of rising rates, IMF warnings of another Eurozone recession, Japan slowing, dramatically slowing growth in China, growing evidence of global deflation and the emergence of currency wars. Clearly, the world's investors retain confidence that central bankers remain willing and able to keep stock and bond prices elevated despite this lengthy list of concerns.

Failure to accept major risks has seriously reduced portfolio performance for the past six years. On the other hand, properly identifying major risks preserved portfolio values over the nine immediately prior years. Over that nine-year period following the dot.com peak in 2000, Mission's risk-adverse approach produced a 5% per year return for clients with the S&P 500 declining by 6% per year. That 11% average annual advantage saved clients from one of the most dangerous periods in U.S. market history. Evidence strongly indicates that at least one more major stock decline is probable before the long cycle that began in 2000 ends. We expect that Mission's appreciation of today's unique risks will serve clients well as this decade further unfolds.

Central bank policies have driven risk-free rates to zero, which has eliminated return for those unable or unwilling to accept investment risk. The Fed has held short rates at the zero bound for more than six years, penalizing savers to rescue overextended debtors.

Those willing to invest in the normally low-risk Treasury bond market may, in fact, be assuming far more risk than they perceive. Longer fixed income yields in the U.S. and around the world are at or near historic lows. At current yield levels, an increase in rates of less than one-half of one percent would turn the total return on a 10-year U.S. Treasury negative for a year. A significant jump in rates would decimate a fixed income portfolio. At these yield levels, the penalty for being wrong in fixed income securities is far greater than the reward for being right.

Fearful of danger to the world's financial system, investors have committed $4.2 trillion to securities providing no yield or a negative yield. In a quest for safety, many are paying for the privilege of loaning money to several seemingly safe countries for periods even up to ten years. This is the quintessential example of investors concentrating on the return of their money rather than the return on their money. There is no comparable example in world history, and it highlights how far from normal are today's financial conditions.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

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To implement their stimulus programs, our Federal Reserve and other major central banks have effectively "printed money." So far, those programs have successfully supported both stock and bond markets, but at the expense of creating historic, formerly inconceivable debt burdens. By horrific example, in its first 95 years the Fed built a balance sheet of just over $800 billion. In just over six years since, it has multiplied that balance sheet by more than 400% to about $4.5 trillion. Over centuries, countries that have created debt burdens even less onerous than today's relative to the size of their economies have suffered economically and in their securities markets for a decade or more.

Compounding the problem, stocks today are more overvalued than at any point in U.S. history but for the dot.com mania at the turn of the century, from which point stock portfolios were more than 50% lower nine years later.

For the third time in the last 20 years, stocks have risen steadily to levels of overvaluation unprecedented before this period. In all three instances, investors willing to ignore fundamental risks, ride the momentum train and believe in central bank guidance substantially outperformed investors who relied on fundamentals and historical precedent. After each of the first two instances, however, despite aggressive Fed support, stock prices plummeted by more than 50%. In fact, the stock market decline from 2007 to 2009 took prices back their 1996 levels, eliminating 13 years of price progress. In the current instance, the Fed has played an even more aggressive role, and the price advance could continue if investors retain their faith in central bank support and control. Confidence in central bankers may waver, however, as investors reflect further on central bank activities in the early months of 2015.

In January, the highly regarded Swiss National Bank, with no warning, abandoned its peg between the franc and the euro, which it had held for 3 ½ years. This so shocked the foreign exchange market that the relative value of the two currencies diverged by 38% in minutes, a move that would normally take years. Soon after, the Austrian central bank indicated that it would not make good on the debts of the "bad bank" set up to house the weak loans of a leading Austrian bank rescued in the financial crisis. And most recently, the Brazilian central bank abandoned its expressed intent to support the Brazilian real. Within three months, three central banks were forced by overwhelming market action to abandon clear commitments, with disastrous consequences to investors who counted on those central bank promises. If investors begin to doubt more broadly the ability of central bankers to support markets, there may prove to be an air pocket beneath prices. As seen in the case of the Swiss National Bank, such consequences can unfold with lightning speed.

As we head into the year's second quarter, investors are faced with the dilemma of whether to align assets with historic probabilities or to cast their lot with central bankers. Central bankers have been winning for the past six years, but with experimental policies that have been penalized throughout history. As has been the case twice so far in the 21st century, capital preservation may soon again prove critical in the period ahead. Mission's great success through the last two major market declines was the reward for our accurate anticipation of the pending problems.

The final page of this analysis summarizes our concerns about threats to the world economy and markets. The cartoon originally appeared in The Financial Times and we have provided annotation and statistics.

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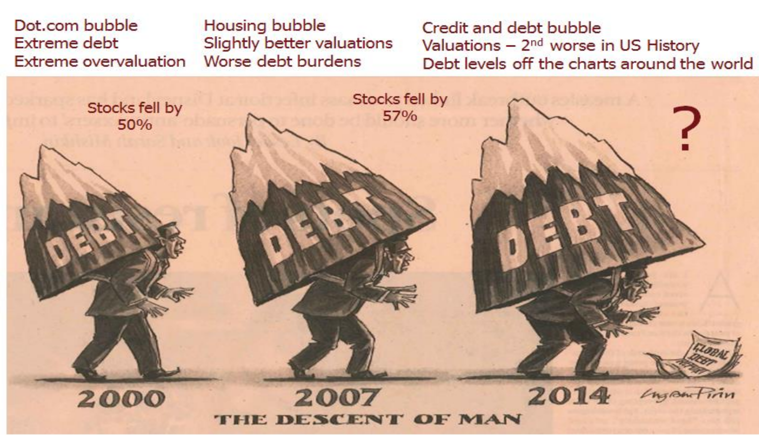

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