CitizensTrust™ A Division of Citizens Business Bank

Investment Outlook

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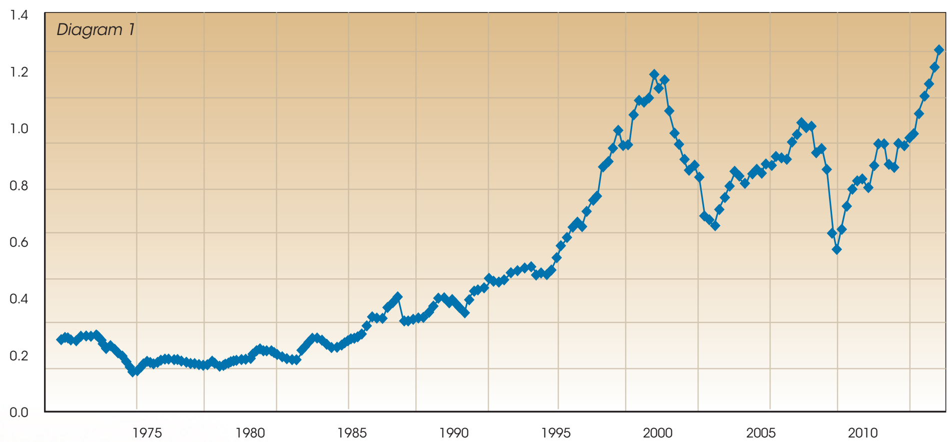
An interesting performance discrepancy has arisen this year as large cap equities and high quality bonds have outperformed their lesser known brethren (aka, small cap equities and high yield bonds). Is this divergence a harbinger of ominous events in the future, a precursor to a reversal of fortune, or a prelude to a 1999 style melt-up? We will explore this phenomenon further in this quarter's note as well as the latest Federal Reserve commentary, the economy, geopolitical unrest, and even touch on the coming election.



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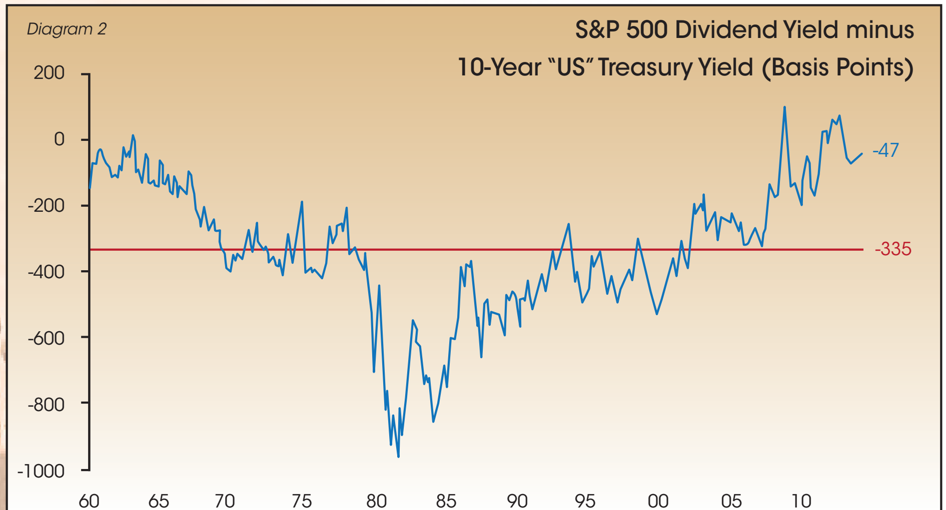
Equity Markets

After a five-plus year rally, the question on many investors' minds is whether the stock market is expensive or not. There are many ways to analyze market valuation, but one of our favorite indicators is comparing the aggregate market cap of the Wilshire 5000 to US GDP, also known as the Buffett Valuation Indicator. As you can see from the accompanying St. Louis Federal Reserve chart *(diagram 1)* this measure suggests that the market is more expensive than at any time since at least 1970. Viewed standalone



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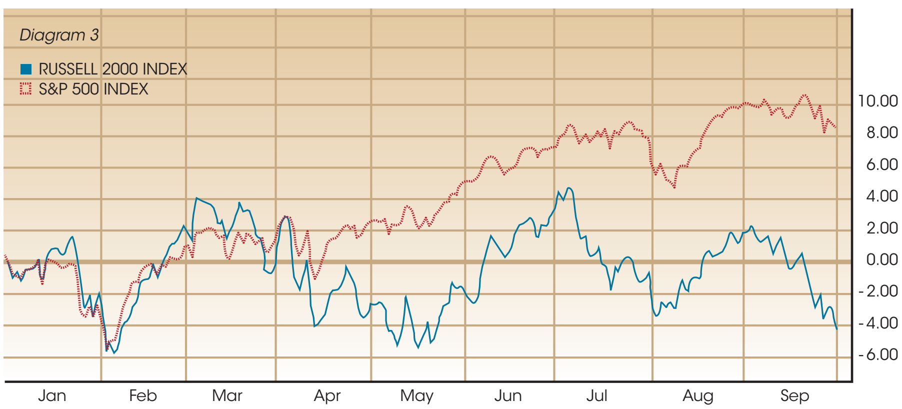
we could conclude that equity markets are overvalued and due for a correction. Fortunately, for equity investors, this isn't the entire story. Valuation must be considered in the context of bonds–and bonds are dramatically more expensive than stocks *(see diagram 2)*. With 10-year treasury yields hovering around 2.5% and the earnings yield of the S&P 500 around 5.6%, stocks are currently significantly cheaper than bonds. While this doesn't preclude a correction in both asset classes, the bias should still lean toward stocks versus bonds in a diversified portfolio over the intermediate to long term. While we are always cautious and certainly feel the market is due for a correction as we enter the 4th quarter, it is our view that domestic equities still offer the greatest opportunity for appreciation until the Fed reverses its present accommodative stance.



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Animal Spirits

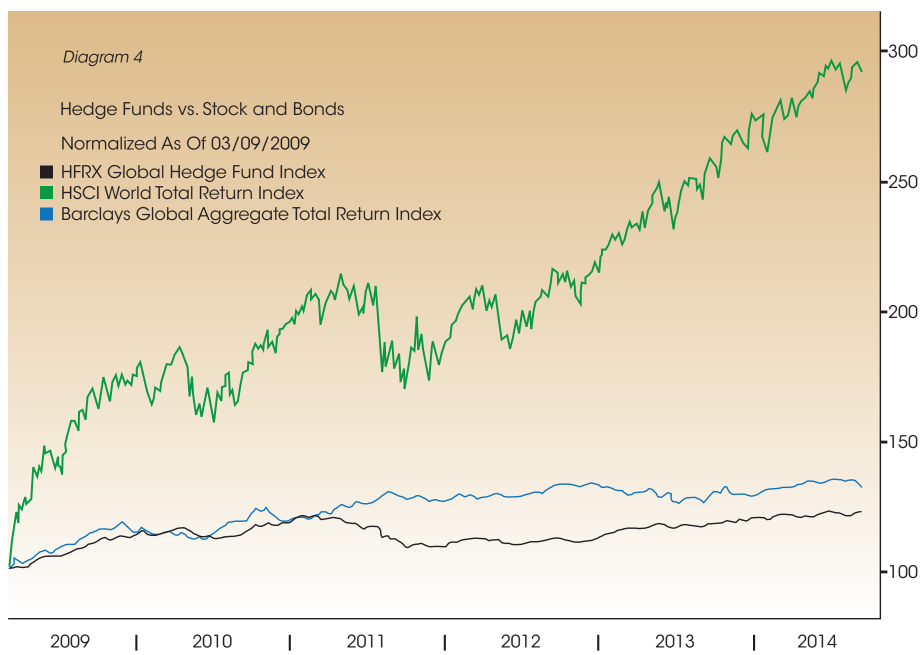
Risk appetite among investors doesn't seem to be wavering as evidenced by the successful initial public offering of China's Alibaba Group (BABA), the largest IPO ever. In spite of raising $25 billion and carrying a market value of $225 billion, the stock jumped 38% on the first day of trading. The company, generously described as a combination of Amazon, Google, EBay, and PayPal, carries significant risk for US investors as the Chinese government doesn't recognize the rights of foreign holders in the stock. This potential risk is evidenced by the actions of two major indices that have chosen to exclude Chinese ADRs from inclusion in their universe.

The New Nifty 50

One of the biggest stories in the equity markets this year has been the outperformance of large cap stocks versus small cap stocks, with the big cap benchmark up 8.3% versus the small cap standard declining by 4.4% *(see diagram 3)*. Some of the outperformance is a result of valuation as small caps carry a significant valuation premium versus large caps, 26 times earnings versus 18 times for large caps. In the past we have experienced periods of market strength while small caps have lagged, most notably 1994-95 when large caps outperformed by 17% and kicked off a marvelous bull market for large cap stocks. We expect this gap to close as either 1) valuations move more in line or 2) the economy shows signs of accelerating. High yield bonds have also underperformed this year, rising 2.9% as measured by the Barclays High Yield Index, underperforming investment grade corporate bonds, which have appreciated over 6%. High yield has often been the canary in the coal mine for equity markets, so the underperformance certainly gives us pause. Recalling past episodes of high yield underperformance reminds us of 1998 and 2006, both of which preceded significant market corrections.

Hedge Funds

Much has been made about the recent decision by CALPERS to terminate all of their hedge fund investments, which total roughly $6 billion. The asset class has been criticized of late for poor performance *(see subsequent chart from David Wilson diagram 4)* and high fees. The chart shows that equities (black line) have dramatically



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outperformed bonds (blue line) over the past five-plus years, while bonds have outperformed hedge funds (brown line) over the same time period. On a risk-adjusted basis, the hedge funds have been the worst investment of the three. While the past isn't always an indicator of the future, it is instructive to note that many investors poured assets into hedge funds right after the financial crisis.

The Economy

In spite of the robust 2nd quarter GDP results (4.6%), the economy continues to muddle along. Recall that Q1 actually declined by nearly 3%, attributable to an extremely cold winter. The 2nd quarter benefited from significant pent-up demand from the slow 1st quarter, ergo the outsized gains. The third quarter seems to be moderating back to trend in the 2.0-2.5% range, with mixed to slightly positive economic indicators *(see diagram 5)*. Consumers continue to be the weak spot as real disposable incomes have declined by 9% over the past 20 years. Housing seems to have paused while corporate spending has been mixed.

Diagram 5	Recent Results	Consensus	Prior Period
Q2 GDP	4.6%	4.6%	4.2%
Chicago Purchasing Managers	60.5	62.0	64.3
Case Shiller Home Index	6.75%	7.40%	8.07%
Consumer Confidence	86.0	92.5	92.4
Pending Home Sales	-4.1%	-1.4%	-2.7%
Durable Goods Orders	-18.2%	-18.0%	22.6%
Initial Jobless Claims	280,000	305,000	315,000
Core Consumer Price Index	1.7%	1.9%	1.9%
Industrial Production	-0.1%	0.3%	0.4%

The Dollar

The US dollar delivered a stellar 3rd quarter, rising 7.7% in the quarter *(see Bloomberg chart diagram 6)*. The strong currency can be attributed to US GDP faring better than other developed economies, more attractive treasury yields, and global instability. The 10-year Treasury bond in the US yields roughly 2.5% and, while near historical lows, is extremely attractive versus German bonds that are yielding less than 1% and Japanese bonds at roughly 0.5%. Regardless of upcoming Fed actions, these relationships don't seem poised to change at any point soon, which should provide continued demand for US Treasuries and the dollar. In spite of the Fed's long running attempts to weaken the dollar, there are many benefits to a stronger dollar. Primarily, the benefits of a stronger dollar accrue to consumers in the guise of lower energy and import prices. The consumer has been damaged by the Fed's easing programs, so the stronger dollar creates a nice tailwind in discretionary income, much more than an increase in the minimum wage could accomplish. The consumer group that benefits the most from a stronger dollar are those who have been most impaired by the Fed's policies, the much maligned bottom 90%. US-based multinationals are less excited about the prospects of a stronger dollar as it makes the prices of their goods less competitive overseas. The flip side of that argument is that most companies still derive the majority of their revenue here in the US, so a stronger consumer should benefit these companies on the whole.

Long Live the King

The "King of Bonds," PIMCO head Bill Gross, announced he is leaving the $2 trillion asset manager he founded to run a startup fund for Janis Capital. Mr. Gross' departure threw the fixed income markets into turmoil, not to mention the daily operations at PIMCO. Investors have voted with their wallets as Mr. Gross' signature product, the $300 billion Total Return Fund, suffered $23.5 billion in redemptions in the first few days after the announcement. PIMCO, which recently moved into a new 440K square-foot building in Fashion Island, has rolled out a major PR campaign to retain assets. Stay tuned.

The Fed and Fixed Income

The Fed met in mid-September, and while the consensus felt that they would change the language in their official statement, the Fed ultimately left their statement intact. The key quote regarding how long they would remain accommodative was left in the statement which noted "policy will remain accommodative for a considerable time." Further, the Fed cited a "significant underutilization" in the economy as a

factor in its decision. We continue to maintain that the Fed doesn't want to raise rates, and that they will keep their policy "accommodative" until inflation becomes a problem. The stronger dollar cited earlier as well as lower energy prices (discussed later) are helping to keep inflation in check. Inflation, as measured by core CPI, continues to run below the Fed's target, giving them plenty of cover to maintain their existing policy.

Oil

Oil prices are down, which is a boon to consumers. Energy prices have declined due to increased production in the US, a stronger dollar, and a significant slowdown in demand. The economic slowdown, combined with more efficient vehicles, has lowered the demand for fossil fuels. In the US, consumption is down to 18.6 million barrels per day versus 21 million in 2006. That is a significant decline that should continue to put pressure on fuel prices until the global economy reaccelerates.

Global Unrest

We mentioned last quarter that global unrest had been increasing, and now we can safely say it is at a 40-year high. Problems in Syria, Libya, Iraq, Ukraine, North Korea, Nigeria, and Iran continue as a somewhat new threat called ISIS takes center stage. This terrorist group was heavily underestimated as the "junior varsity" before a series of beheadings put them on the center stage. After literally ignoring ISIS for a number of years, the US has begun a bombing campaign to assist in controlling the group. Forgive us for sounding so cynical, but we find the timing of the bombing, just six weeks before the election, somewhat specious.

Elections

Speaking of the elections, many pundits feel that the Republicans will gain enough seats to control the Senate. We've reviewed the math and the scenarios required for this to occur, and we are doubtful it will happen. In spite of the major gaffs coming from the White House, it is our opinion that the Republicans haven't done enough to differentiate themselves during this election season. Additionally, Republicans have been heavily outspent by Democratic PACs and, instead of conveying a message, they have spent most of the election season defending themselves.

Twelve governors from both parties are on the hot seat for re-election due to a Carter-era malaise that has only 23% of Americans feeling the country is moving in the right direction. When voter discontent is this high, incumbents, especially governors, tend to lose their re-election bids with surprising frequency.

International

In addition to the global unrest we discussed earlier, there was also some political unrest that almost resulted in a dislocation of one of our key allies. The Scottish voters rejected a measure that would have separated Scotland from the UK. While the polls showed the bias to be barely for remaining as is, many theorized that younger voters were more in favor of the separation and weren't represented well in the polling. In the end, voters decided to remain with their long-time alliance.

The global economy is slowing, which is positive for inflation and the dollar, but a concern given the weak economic condition of much of the world. Former growth-standard bearer, China, has been showing signs of slowing for a number of quarters, and now is taking actions to encourage borrowing by small businesses. This is quite a change from two years ago when the Chinese were trying to figure out how to cool off the country's rampant borrowing. Japan has also slowed after a short-lived economic bounce as consumer spending declined by 4.7% in the most recent quarter. The Eurozone is also slow and has possibly entered a recession.

CitizensTrust Focus

While the world continues to be complex, we continue to stay the course in our investment philosophy. Our disciplined investment process helps us maintain a well-balanced, risk-appropriate portfolio designed for your needs. We continue to appreciate your trust in us, and look forward to continuing our relationship with you. We wish you and your family a wonderful holiday season; we look forward to speaking with you soon.

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"Before Google, there was memory." -unknown

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