CitizensTrust™
INVESTMENT PERSPECTIVES

Citizens Business Bank
A Financial Services Company

Q1 2016

R. Daniel Banis
Executive Vice President
Head of CitizensTrust

Ned W. Brines
Senior Vice President
Chief Investment Officer

CitizensTrust
A Division of
Citizens Business Bank

If we were to jump in a time machine, set the date for 2025, and look back at 2015, we might conclude it was a sleepy year based upon the market results.

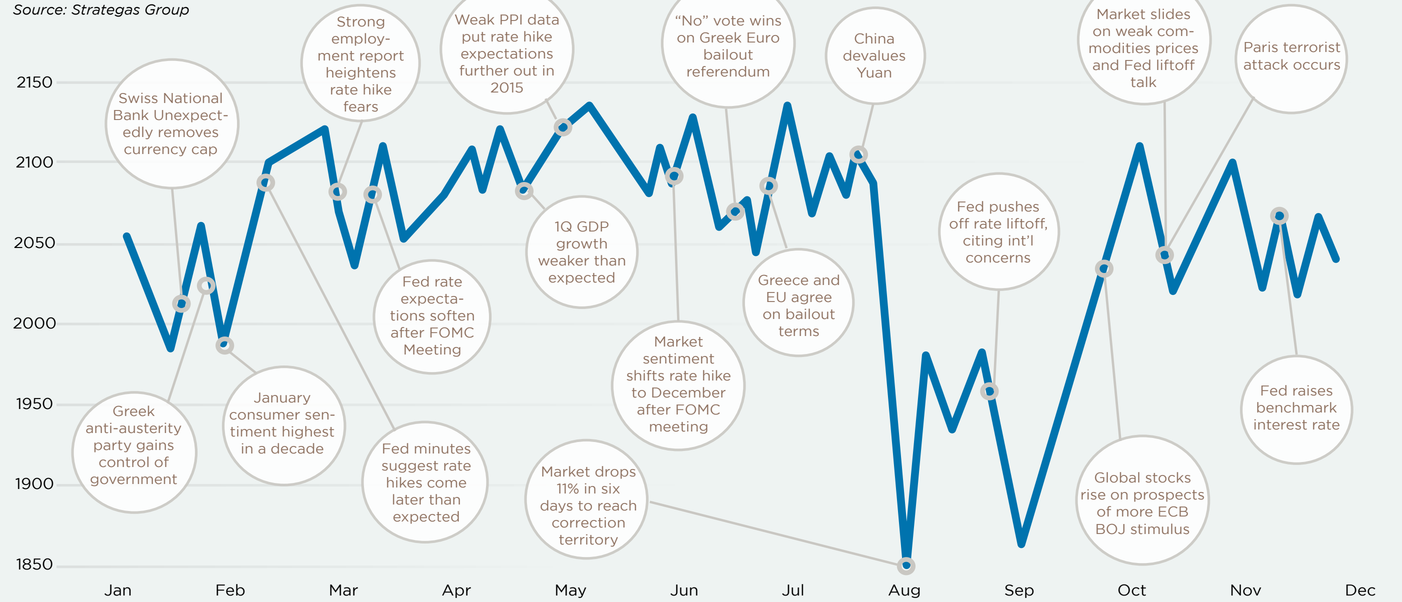
As those of us who lived through the past year can attest, 2015 was anything but sleepy. Volatility jumped, equity markets corrected, oil collapsed, global instability and terrorism increased, China swooned, the dollar soared, Donald Trump became a leading Presidential candidate, and the Fed finally raised rates! Whew! All of that action resulted in a paltry increase of 1.4% for the S&P 500 and 0.6% for the Barclay's Aggregate Bond Index. For the first time since the financial crisis, cash was competitive with other assets, posting a 0.1% return for the year. In short, 2015 was the worst year for asset allocation in the past 80 years as diversification looked more like "diworsification."

EQUITY MARKETS

After years of market strategists calling for it, we finally experienced our first true equity market correction since 2009, with the S&P 500 declining 12.5% from its May high of 2134 to a low of 1867 in August. While harrowing and uncomfortable, we advised holding course and witnessed a 9.4% rally into year end to reach the market's final performance of 1.4%. Volatility, long dormant since the market rally began in March 2009, spiked as investor fear raged during the summer correction.

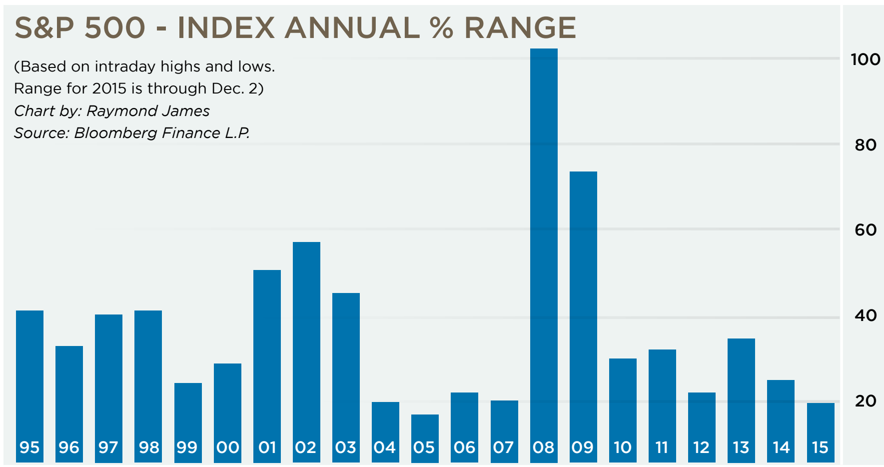
The chart below, courtesy of Strategas Group, shows the anatomy of 2015's below average return. As you can see there were a number of significant events that contributed to the market's movements throughout the course of the year, including a Greek austerity program, a Fed rate increase, terrorist attacks on virtually every continent, a China currency devaluation, and stimulus from both the ECB and the Bank of Japan.

S&P 500 - 2015 ANATOMY
Source: Strategas Group



We believe it was a brokerage firm that coined the mnemonic "FANG" to describe this year's market; however, we altered it to "FANGS." What is FANGS? FANGS represents five stocks (Facebook, Amazon, Netflix, Google, and Starbucks) which together provided virtually all of the market's returns in 2015 (74% increase on average). Without these five stocks the S&P 500 would have declined for the year. The Wilshire 5000, which is more representative of the average stock than the S&P 500, declined by 2.3% during 2015. While there are always stocks that outperform during the year, this type of concentration is reminiscent of prior market peaks and certainly qualifies as an equity market canary.

In spite of the correction and rebound in the equity market, 2015 was an extremely range bound market as can be seen in the chart below, courtesy of Raymond James. If we ignore the slump in August and subsequent recovery, 2015 would be the first year with a single digit intraday range since World War II.



The market's valuation remains slightly above average at 17.4x the 2015 EPS estimate and 16.0x the 2016 estimate. Why the close valuations for both years? This is driven by expectations of another flat year for S&P 500 earnings. While we anticipate improved earnings for consumer and service companies, we also expect continued weakness in energy, commodities, and manufacturing companies in 2016 which should keep earnings growth at or close to zero in 2016. Margins have peaked at a record 9.2%, up from 4.7% at the end of 2008, and we are expecting them to decline somewhat as debt service and employment costs increase.

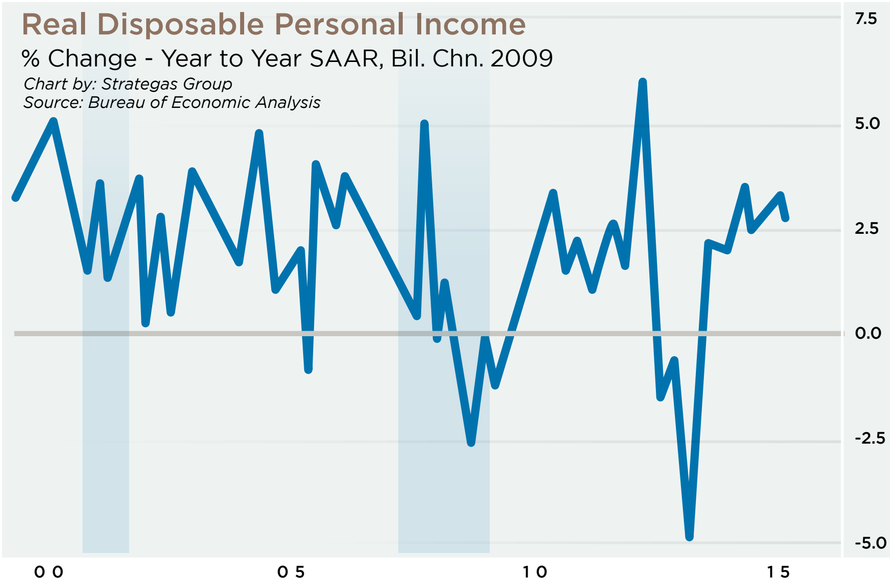
Mergers & Acquisitions

Mega deals were the rage in 2015 with 56 deals exceeding $10 billion during the year, surpassing the old record of 44 in 2006. The biggest deal is Pfizer's attempt to purchase Allergan for nearly $200 billion. Additionally, initial public offering (IPO) activity was the lowest since 2009 and, when combined with the large share buyback activity and mergers & acquisitions, resulted in less stock outstanding in the overall market. A lower amount of shares outstanding helps create support for the market as there is less stock available to purchase at a time when foreign capital flows are moving into the US because of the strength of the dollar.

The Economy

Gross domestic product (GDP) for 2015 should come in as anticipated at 2.5-2.7% growth. For 2016 we are expecting GDP growth of 2.5-2.8%, and anticipating a 3.2% increase in consumer spending, 1.4% increase in government spending, and a 3.0% increase in private investment, all contributing to our estimate. The offset to these categories is net exports, which are expected to decline next year.

The Fed's biggest conundrum has been the low labor participation as 35% of adults are presently not in the workforce versus 31% a decade ago. It is interesting to note that if just half of that 4% decline in the workforce were to return, the unemployment rate would jump to an uncomfortable 7.0%. Those who have left the workforce include retirees and an unusually high number of 20-24 year olds who report themselves as "retired," not seeking jobs, and therefore out of the workforce. This is unusual and could be attributed to either poor job prospects for recent college grads or, more optimistically, millennials participating in types of work not captured by traditional measurement methods. In all of the job discussions this year, one data point that seems to have gone unnoticed is that job cuts were higher



in 2015 than any year since 2009 at 270K in the US and 855K globally.

Manufacturing has weakened due to overzealous regulation, weakness in commodities, and a stronger dollar. In December the ISM Manufacturing index posted the weakest results since June 2009, coming in at 48.2. This measure has been declining all year and doesn't bode well for US exports or employment.

Small business surveys are suggesting that labor markets are tightening and wage pressures have been appearing in certain locales and industries. Real disposable income has improved as employment stabilizes and competition for employees has forced employers to increase compensation in order to retain top employees. In addition, lower energy costs have freed up income for other purposes and, while it took time to develop, consumers have become comfortable with lower fuel costs and have been increasing their discretionary spending. Consumer spending constitutes roughly 70% of US GDP, and we are forecasting an increase of 3.2% in 2016, slightly better than 2015. The chart above, courtesy of the the Bureau of Economic Analysis and Strategas Group, shows the growth in real disposable personal income since 2000.

Star Wars

Disney paid $4 billion for Lucas Entertainment in 2012, but based upon the success of the recent Star Wars release, it appears the investment will be a solid one. Star Wars: Episode VII The Force Awakens is expected to gross between $2.5-$3.0 billion when it completes its run and video release after a record $529 million opening weekend. After eighteen days, the movie broke Avatar's US and Canadian box office record of over $700 million. Additionally, Disney plans massive product extensions into characters, theme park rides, and other videos to further enhance revenues from this newly acquired content. Sales of the prior six episodes have been soaring as well, and the company announced a release schedule for sequels and spinoffs. Recall that Episode VII is the first Star Wars release since Episode III Revenge of the Sith in 2005 and, once Episode IX is completed, the franchise will be close to 45 years old!

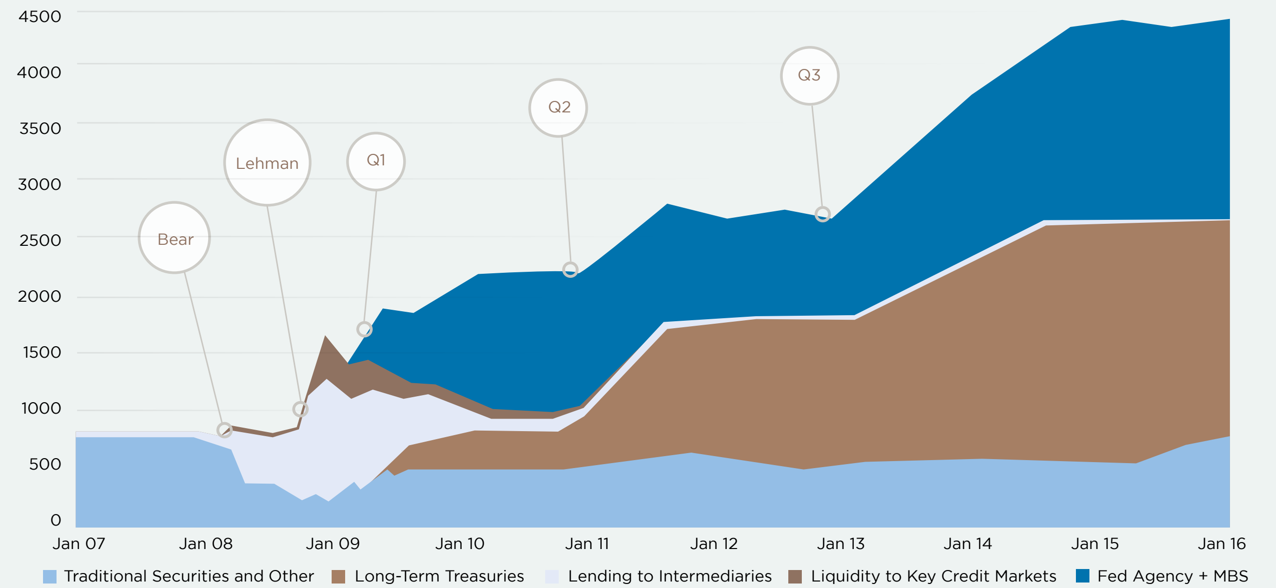
The Fed and Fixed Income

Almost 10 years after the last Fed increase, and over two years after discussions began about raising rates, the Federal Reserve finally raised short-term rates in December. This was the first rate increase since 2006, and is the first time the Fed Funds rate has been above zero since 2009. While these aren't signs of inflation or an overheating economy, typically the indicators required for a rate increase, the Fed is focused on moving toward a more "normal" monetary policy and away from the emergency policy we have been in since 2009.

Yet to be addressed by the Fed are their plans to unwind the unprecedented increase in their balance sheet. As can be seen below, each Quantitative Easing (QE) program has dramatically increased the Fed's balance sheet, which is now near $4.5 trillion. How will they bring those securities back to market? What will be the impact of them no longer purchasing assets in the market? What will happen to the budget deficit if rates were to rise and the value of this portfolio declines? All of this is unknown as we have never seen a balance sheet increase like this in the past, and the Fed hasn't discussed plans to unwind these positions.

The Fed's Balance Sheet Growth

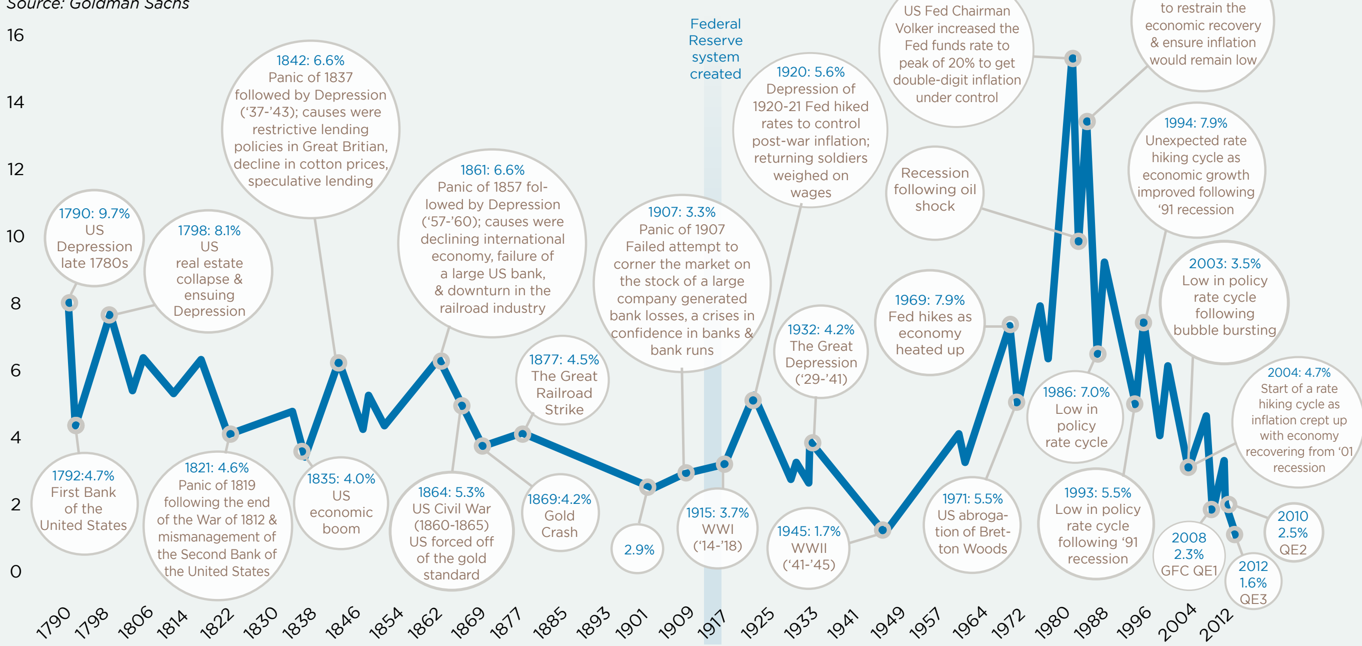
Source: Strategas Group



Despite dipping as low as 1.64% in late January, the 10-year treasury finished 2015 at 2.27% after starting the year at 2.17%. In spite of the Fed's recent increase in the Fed Funds rate, longer term treasuries have failed to respond, suggesting a flattening of the curve, which traditionally has signaled economic weakness in the forward months. Last year we discussed this at length and, while there is a possibility that rates will accelerate upward, we continue to anticipate a controlled rate environment, especially in the 7-10 year window. The chart below, courtesy of Goldman Sachs, shows the long-term history of 10-year yields. Although the chart ends at 2012, note that rates are not measurably higher today than they were in 2012.

The Long History of Long (10-Year US treasuries) Yields

Source: Goldman Sachs



Investors stretching for yield had an appetite for investment-grade corporate bonds as sales reached $1.3 trillion in 2015, a new record. The 2015 issuance, from 967 different companies, represented an 8% increase over 2014. The largest day of issuance was in early March and exceeded $37 billion! High yield suffered its first decline since 2008 as energy companies dragged down the indices. High yield fell by 5% during the year, but the lower-rated securities fell an average of 15% with some falling by as much as 70%. Retailers also began showing weakness as Amazon's success in selling low-priced goods has pressured foot traffic and margins for many retailers without a differentiated product offering.

Energy

The much ballyhooed collapse in oil prices had a positive effect on consumers, who saved an average of $540 in 2015 as a result of lower gasoline prices. In business there is never a yin without a yang, and the drop in oil prices isn't immune from this rule. While bullish for consumers, the decline has put pressure on the energy and capital equipment sectors, both of which have been bright spots of employment growth since the financial crisis.

We believe that there is still significant capacity that needs to be removed from global oil production before prices can stabilize. As can be seen from the chart to the right, courtesy of The Big Picture Financial Blog, history is on our side as oil recoveries have typically taken many years to play out.

Alternative Assets

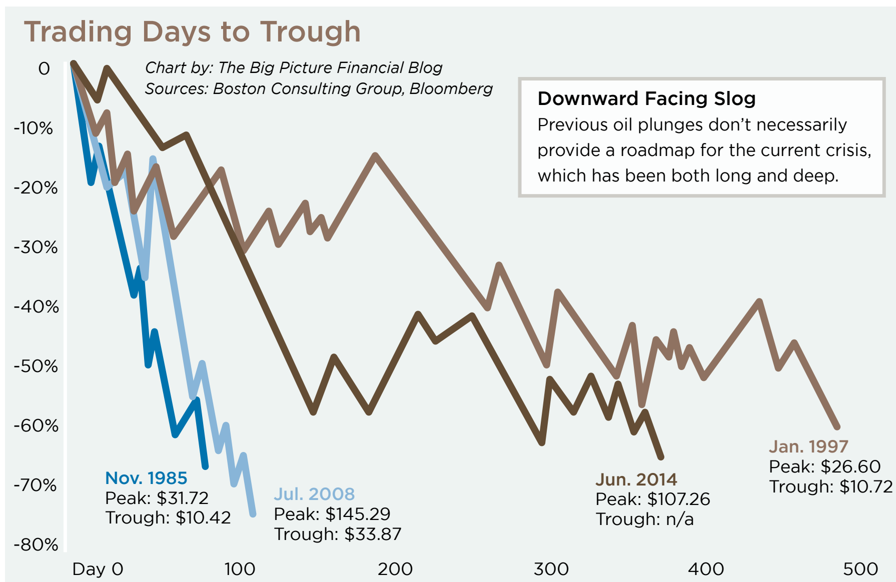
Hedge funds continued their struggles in 2015, posting another year of weak returns with a combined increase of less than 1%. Hedge funds in aggregate have underperformed dramatically since the financial crisis ended. Many large investors, including CALPERS, have begun reducing their exposure to hedge funds due to the higher fees and questionable risk-reward characteristics. Being contrarians we tend to migrate toward out of favor assets; stay tuned.

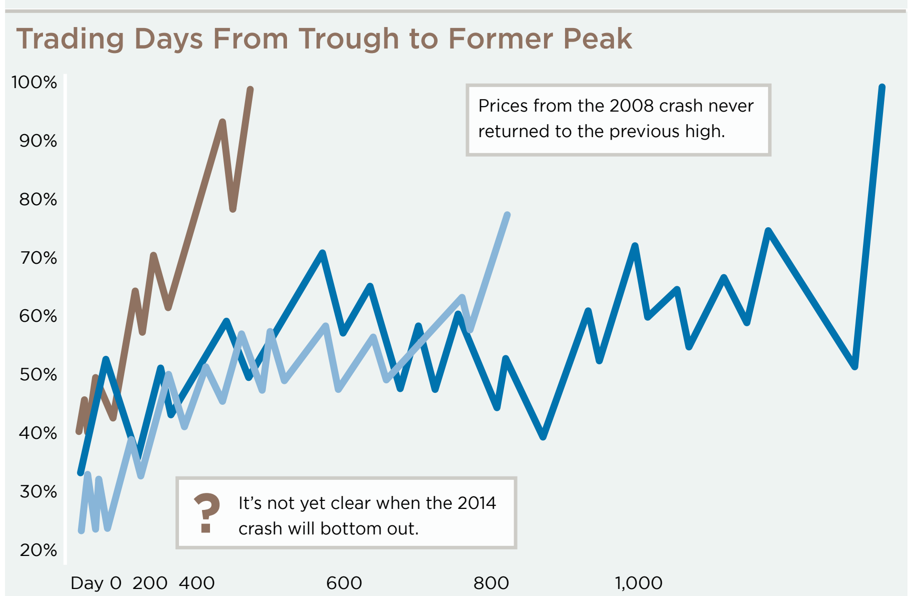
Fiscal Stimulus

New speaker Paul Ryan pushed through a bill that suspended the sequestration caps until March 2017, which should add 0.6-0.7% to GDP in 2016. Discretionary and defense spending will both increase in 2015-2016, the first defense increase in five years. The budget deficit is also anticipated to increase in 2016 by 0.9% to 3.5% of GDP, or $634 billion, and an estimated $750 billion in 2017. It would appear that austerity is good in Washington except in an election year, when it's spend enough to get reelected.

International

Europe went "all in" with their quantitative easing program a year ago, and the recovery has been slow and steady. At one point we felt that Europe was effectively in a recession,





but for 2016 we are expecting slightly positive GDP growth of just over 1%. Manufacturing in Europe has been expanding at the fastest pace in almost two years with even Greece showing an increase in December, the first increase since early 2014. Spain, once one of the PIIGS countries, now has the strongest economy on the continent.

After decades of consistently strong GDP growth, China has been the villain in the global economy as it struggles to migrate from a manufacturing-driven exporter to a consumer-driven economy. Their growing pains remind us of Japan's in the late 1980s. We just hope they are able to learn from that debacle and are able to navigate their way through this growth morass. Manufacturing in China has been weak, declining for five consecutive months to end 2015. Financial reforms and commodities exploration have been occurring at a rapid pace in the country, but with great change comes great risk.

What We Thought for 2015

In our year-end note last year we made six predictions and, while we didn't go far out on the limb with them, we were correct with five of them. Our predictions for GDP, oil, US wages, the Fed, and global unrest were correct. We missed on S&P 500 earnings and performance, overshooting as we underestimated the impact of declining oil and the strengthening dollar on S&P earnings.

For 2016 we are anticipating slightly stronger domestic GDP as increased consumer and government spending offsets any negative impact from higher short-term rates and lower net exports. Our target GDP is 2.5-2.8% for 2016. We anticipate the Fed will raise rates at least three and possibly four times in 2016, with the Fed Funds rate ending the year around 1%. We continue to anticipate weak international growth, with Asia and China showing weakness while Europe's economy improves slightly.

Conclusion

2015 was a difficult but not unprecedented year for investors. We continue to focus on maintaining our asset allocation and risk adjusted returns discipline to ensure our long-term results match the needs of you, our client. Once again, we wish you a Happy New Year and successful 2016. We appreciate your continued support and business, and look forward to seeing you soon.

> *Intelligence is the ability to adapt to change.*
> *-Stephen Hawking*

CitizensTrust™

Wealth Management

www.cbbank.com/CitizensTrust