BSIF
STUDENT INVESTORS

Macroeconomic Report

Fall 2014

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Introduction

BSIF's biannual economic report serves the Fund in its top-down approach. Its purpose is to educate members about current macroeconomic trends and events. This applies to the domestic, global, and sector levels, providing members with the required background knowledge for stock pitches. Economic information for each sector provides an objective reference for pitch groups. At the same time, this information allows voting members to consider the macroeconomic implications of proposed stocks to improve voting decisions.

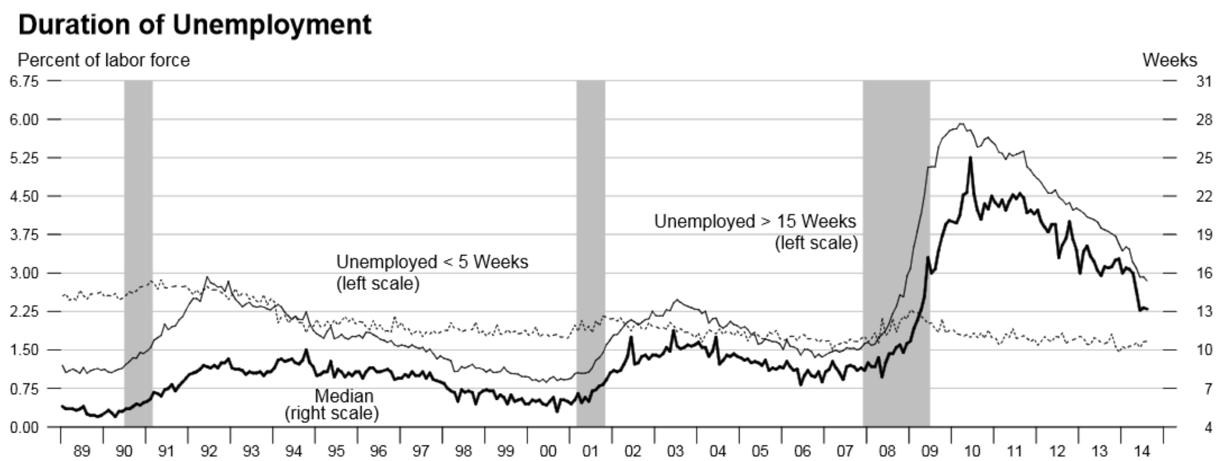
- **Overall State of the U.S. Economy**

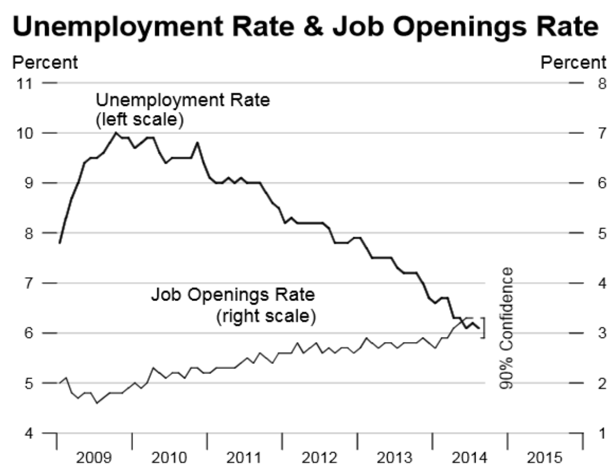
The U.S economy holds its own despite recent setbacks in the rest of the world:

- GDP growth rates are expected to remain in the 2.0% to 2.5% range for some time. There was a surge of activity this spring leading to a turnaround from a terrible winter, which had disrupted factory production and had kept consumers away from shopping malls.
- Demographics are problematic: Lower population growth rates and an unfavorable mix shift to older, lower-spending consumers will keep a lid on long-term economic growth.
- Recently there has been a new-found strength in business investment, growing at an annual rate of 9.7 percent in the second quarter, significantly above estimates.
- Export sales have been increasing.
- Analysts expect the U.S. to finally enter a period of above-trend growth in 2015 supported by falling unemployment levels and growing payrolls which should translate into stronger consumer spending.
- The U.S. economy continues to have a capacity gap (a fancy way of measuring capacity utilization that includes labor) which is close to 5%.

- Cheap money allows struggling and highly leveraged companies to operate without trouble. However, interest rate hikes are likely to increase defaults and bankruptcies.
- The future will be impacted by the FED's decision to increase interest rates. Currently there is still a lot of disagreement among FED's regional presidents.

- The world economy is not as good as the US: The IMF reduced its outlook for potential growth. Weakening international economic outlooks will keep impacting U.S. companies and contribute additional volatility to U.S. markets.

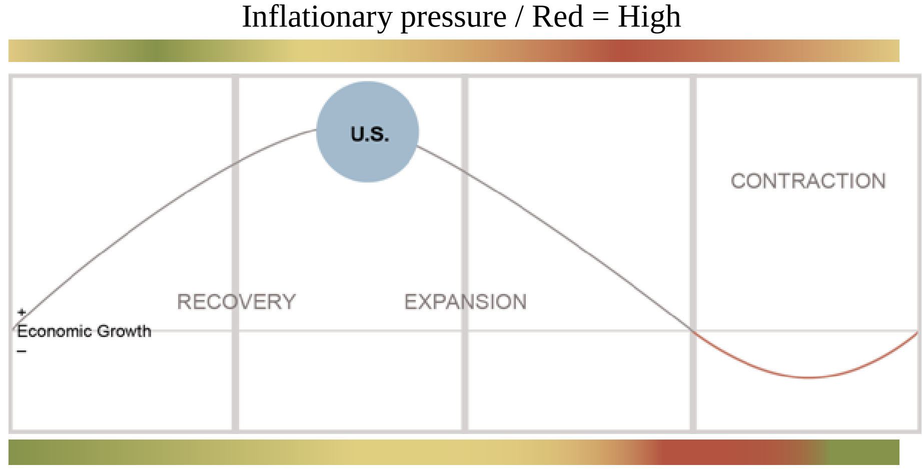




- **Business Cycle Analysis**

The U.S. remains firmly in a mid-cycle expansion; however, the global business cycle remains divergent across countries.

Inflationary pressure / Red = High



Top axis: Relative performance of economically sensitive assets / Green = Strong

- The economy is close to its peak, thus stocks that outperform starting in the middle of the economic recovery are desired.
- Defensive sectors do relatively well during times of high inflation.
- Higher risk for bubble/correction: Driven by excess liquidity and a lack of alternative opportunities, a lot of money has flown into equity markets. Stock markets made huge gains even though earnings were not that good. Thus BSIF needs investments that are “stable” and not hyped up.

- **Current Corporate Trends**
    - **Inversions** U.S. corporation changes its country of residence
    - **Merger & Acquisitions** fueled by “cheap” money

Several high profile companies have more recently indicated an interest in merging or plans to merge with a non-U.S. headquartered company, including Medtronic, Mylan, Chiquita, AbbVie, and Burger King. For companies which have accumulated substantial profits in subsidiaries in low tax foreign countries that would be taxed if paid to the U.S. parent, the territorial tax system is likely the most important tax benefit from such a merger. This “second wave” of inversions again raises concerns about an erosion of the U.S. tax base. The government currently considers various options to combat this.

- **FED: Outlook Interest Rates / Inflation (banks):**

- The Federal Reserve has been the main topic of discussion in the investment of what they are going to do next. In September when Yellen held the Fed Press Conference she hinted at an interest rate hike in June 2015.
- According to that Press Conference she was going to raise terminal rates to up to 1.375% with a long term focus of 3.75% by the end of 2017.
- However the Fed might not raise interest rates in 2015 due to global growth concerns and the strength of the dollar. This has been supported by the latest Fed FOMC minutes that came out on October 8, 2014. Short term guidance for short-term rates might get adjusted which means there might be no rate hike by June 2015 and there might be a rate hike by the end of 2015.
- Because of this we anticipate that all US Indices will rally and financials will lag but from this we still advise for the Fund to invest in a solid bank or two as we think they are reasonably priced and undervalued. This might be a good entry point for financials.
- The Fed is not behind the curve because interest rate decisions should be based on data and there is so much slack in the labor market and a disconnect in the housing numbers.

- **Indicators**

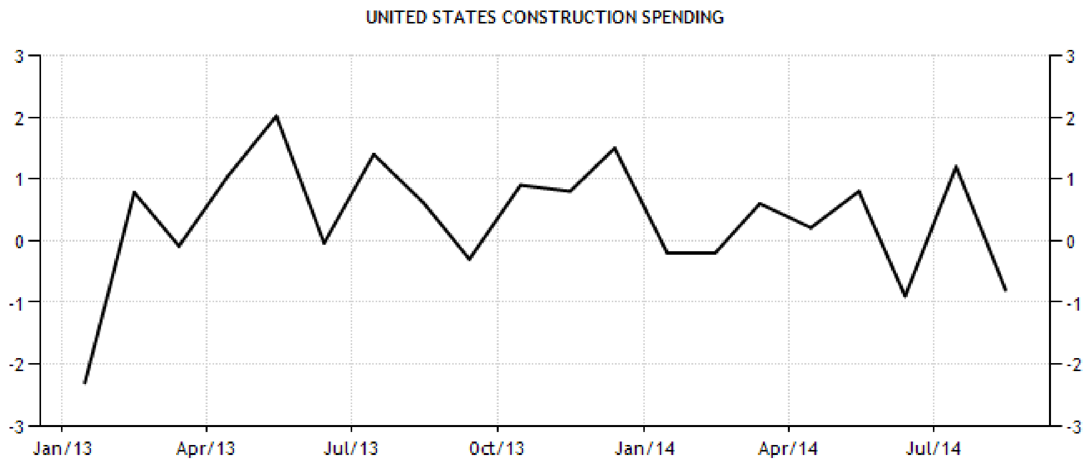
   a. Jobs

- The Unemployment rate currently sits at 5.9% we have seen an improvement in the amount of jobs being created since the recession in 2008. Last Month the 248000 jobs created beat expectations of 210000 jobs.
- Job openings have increased to their highest level since 2001 currently there are 4.8 million job openings. This is a sign of significant growth in the economy and there is evidence that the recovery is on track.

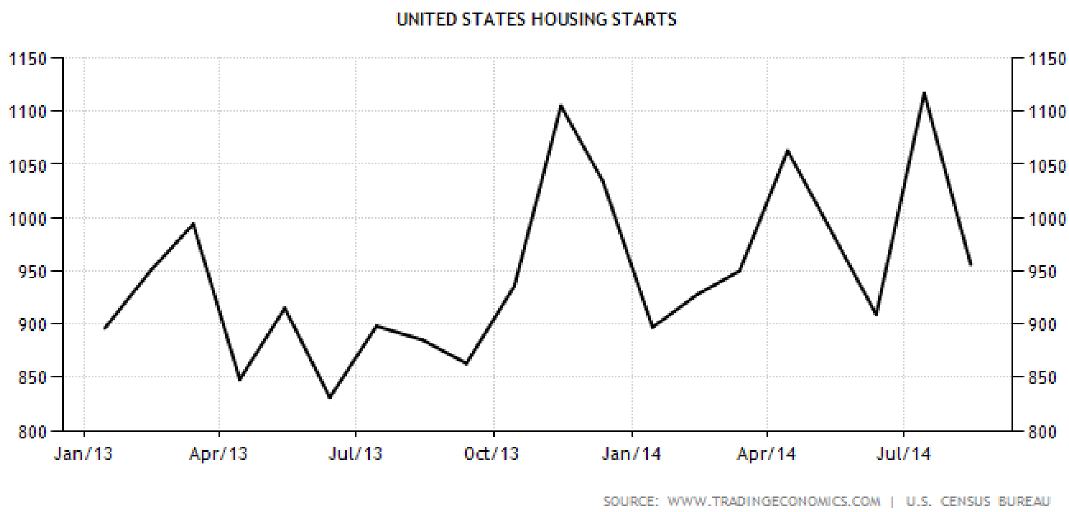
- This graph shows that the unemployment rate has been steadily declining but the rapid drop can be noted in Q2 where the unemployment rate dramatically decline from 6.6% to around 6.1% at the end of Q2.
- Although the unemployment rate has significantly declined there is still slack in the labor. The Congressional Budget Office (CBO) has sighted that the labor participation rate is still low and they project a potential surge in labor participation and they predict that the unemployment will rise again maybe to around 6.5%
- This is why the Fed has continued its cautious approach about interest rates as they still think there is slack in the labor; however, from the last year jobs have improved.

b. Housing

- The Housing story has been a mixed bag as there has been sluggish growth in construction spending and this indicator has been highly volatile as seen below:



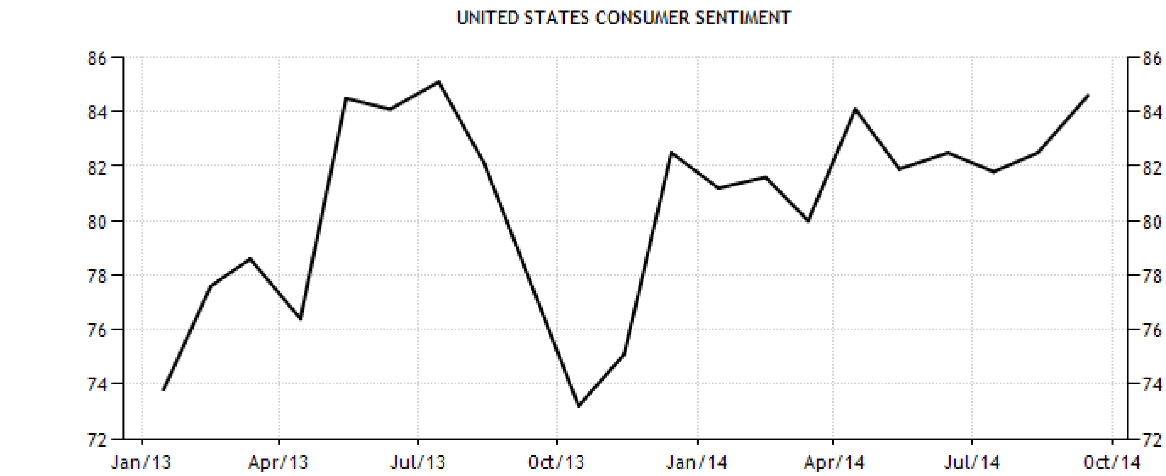
- Housing Starts in conjunction with construction spending has been highly sluggish and they have been highly volatile:



- The Housing recovery has much more room to grow and there is a new trend that people are not actually buying new houses and are actually renting instead. This can be supported with the fact that mortgage applications have decreased by 4.3%.
- But there is a sort of a disconnect in the Housing sector as new home sales and existing home sales have improved by roughly 2-3% during Q2.

c. Consumer Sentiment

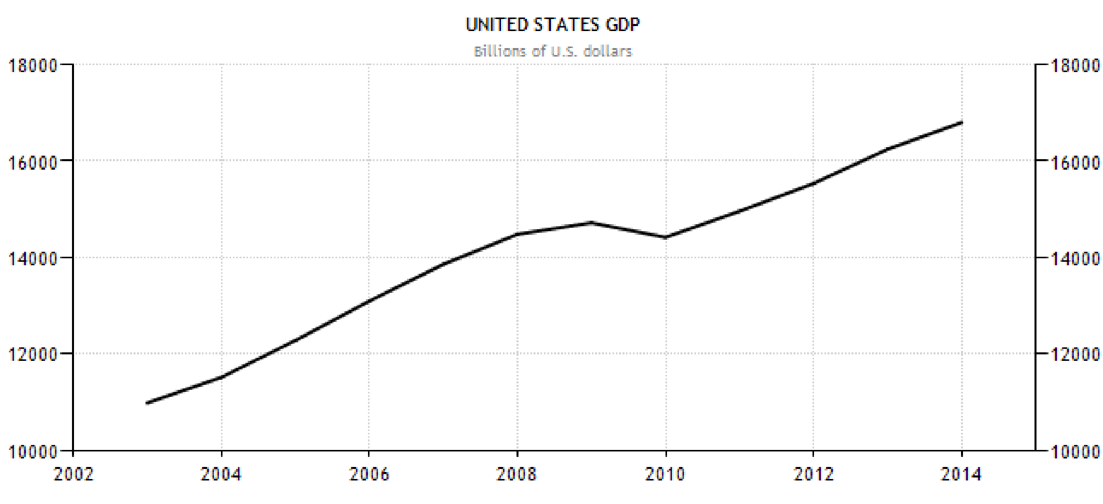
- Consumer sentiment has continued its rise since its plunge in Oct 2013. With the lower oil and gas prices this has helped the consumer to spend more and with the prospect of an increase in wages we expect the consumer outlook to be positive.
- This is an important indicator of the economy as the US economy is mostly consumer driven.



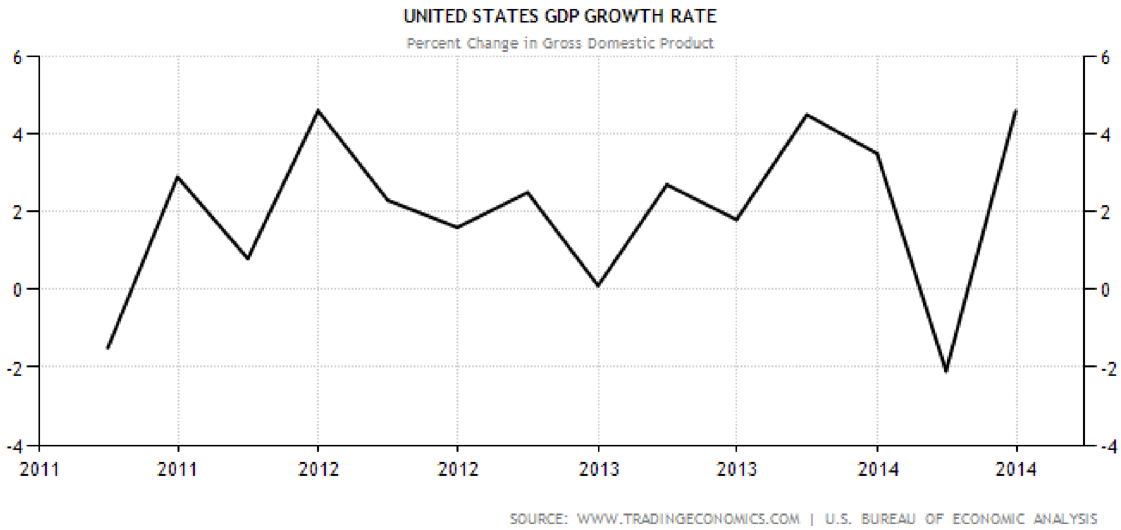
- Consumer spending has increased by roughly 12.1% to support the improved consumer sentiment. There has been an increase in the amount of disposable income as that has gone up by roughly $360 Billion from Q1 2014. However the only concerning thing about consumers is that their wage growth has been stagnant and they have been helped by low inflation on goods.

b. GDP

- GDP has slowly been on the rise in the US and has vastly improved since the 2008 financial crisis, this is because of Fed QE and low interest rates.

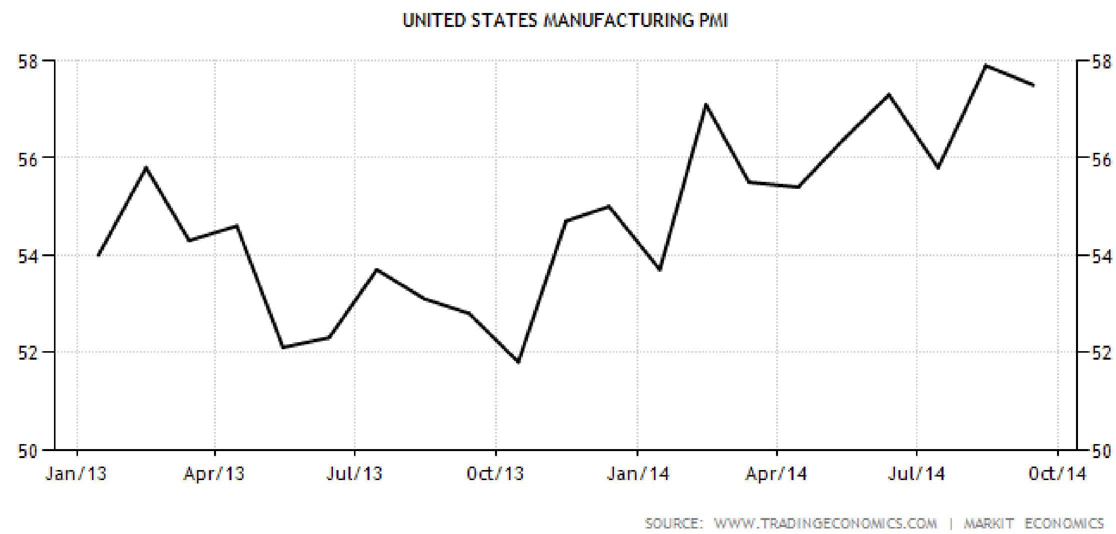


- However looking at 2014 it has been a mixed bag: 2014 Q1 was a huge disappointed as the economy shrank 2.1% and this has made the Fed slow down QE and their interest rate hike. However this was offset by the 4.6% growth in Q2. And overall the economy grew 2.5% we forecast 2014 Q3 will have GDP growth of between 2-3% but this remains volatile because of housing and tapering.

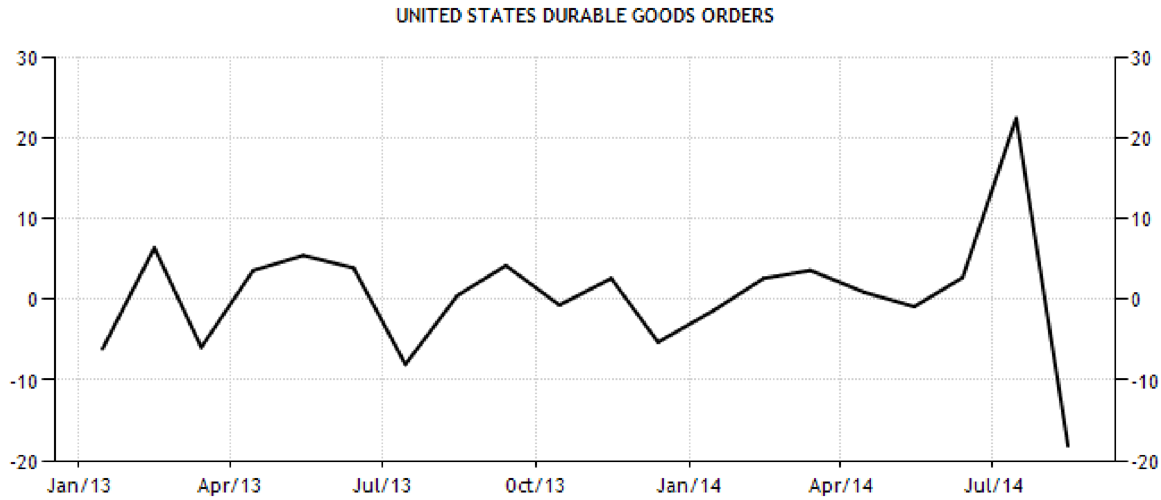


a. Production

- Supported by the good and improving GDP, the Manufacturing PMI has been highly volatile but has been on an upward trend as anything above 50 on the Manufacturing PMI shows growth and expansion.



- The Durable goods orders has been disappointing with a recent decline of 18.2% in Durable goods orders this has been because of the political storm that has brewing at Washington about the Import and Export Bank that funds other developing countries like India, Egypt etc. These countries receive loans to purchase military or commercial planes or heavy machinery for construction. The future for that has been causing this high volatility. Recently Washington just passed a bill for more additional funding until December so we see the durable goods number improving later in Q3 and Q4. But the future of the import and export bank is uncertain and it will affect industrial stocks and basic materials stocks.

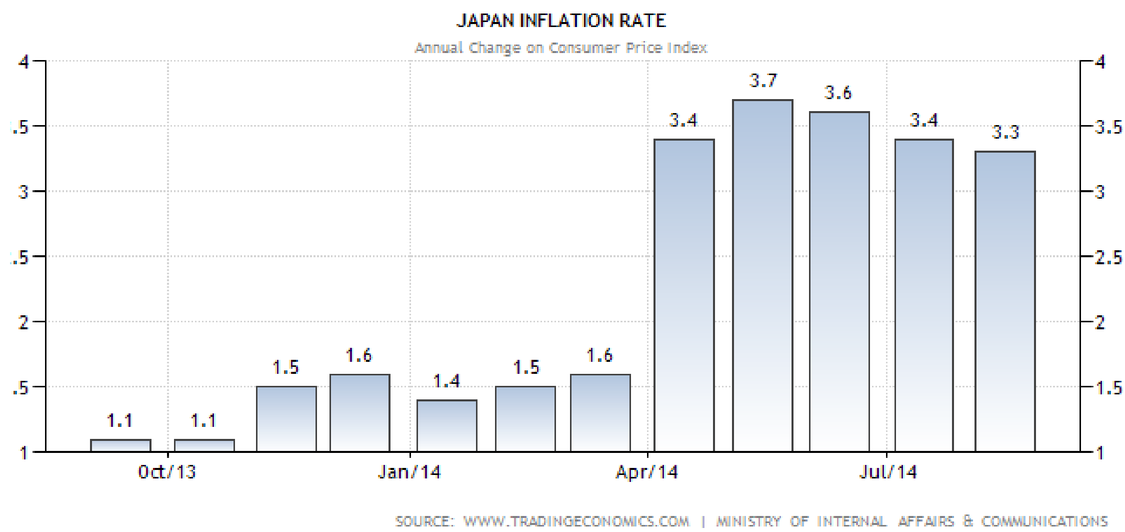


- **Global Outlook**

a. Asia:

- **Japan** is expected to be bullish under Prime Minister Shinzo Abe, bringing the economy out of stagnation:
  - **Bullish:** Prime Minister wants to achieve sustainable growth through structural reforms. Japan no longer establishes nuclear power plants, agricultural reforms, free trade agreements implemented
  - **Bearish:** The market is skeptical on Abenomics. Japan's domestic confidence depends on US and China's economy. The economy may still be stagnating.

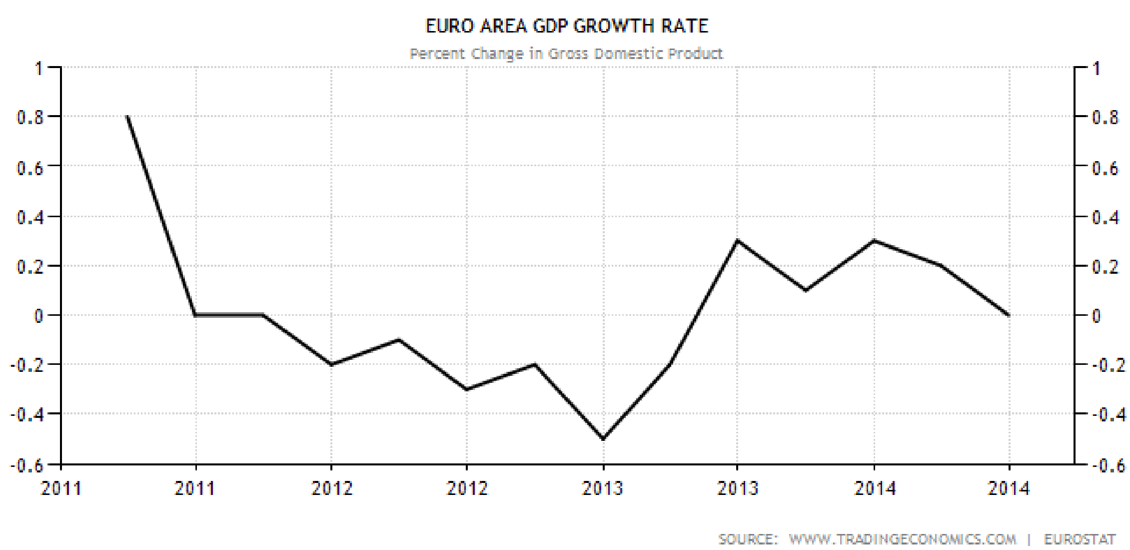
  - Japan's target inflation rate is 2%



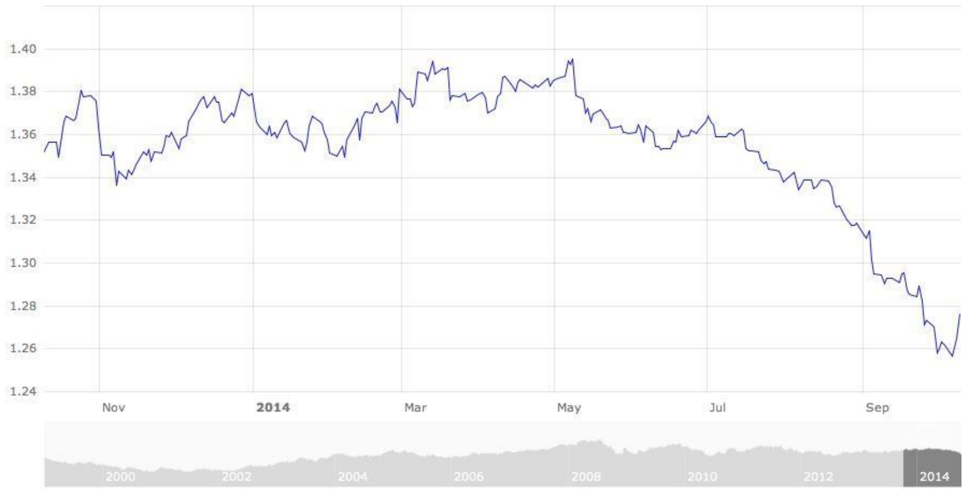
- **General Outlook in Asia: Security and New Risk**
- Expect political instability in Asia- Taiwan, Hong Kong and Thailand (Protest)
- Tensions and uncertainties in the Korean peninsular
- India shows promise, new government (Mohdi) prepares to stimulate investment.
- ASEAN countries growth expected to slow down
    - Malaysia: strong growth
    - Indonesia: Weak commodity export
    - Thailand: Political disruption
    - Philippines: government spending slowdown
    - Vietnam: low domestic demand

b. Europe

- Situation in Russia affecting all of Europe, specifically Germany
- Russian Rouble at 40.11. Record lows despite gov. optimism.
- Germany was declining but began to increase today: 10/9/14
- German Chancellor, Angela Merkel, wants to increase government spending to push along the slow and stalling economy.
- "For governments that have fiscal space, then of course it makes sense to use it," -Mario Draghi, President of European Central Bank
- US economy is stalling and dropping due to fear of global economic instability



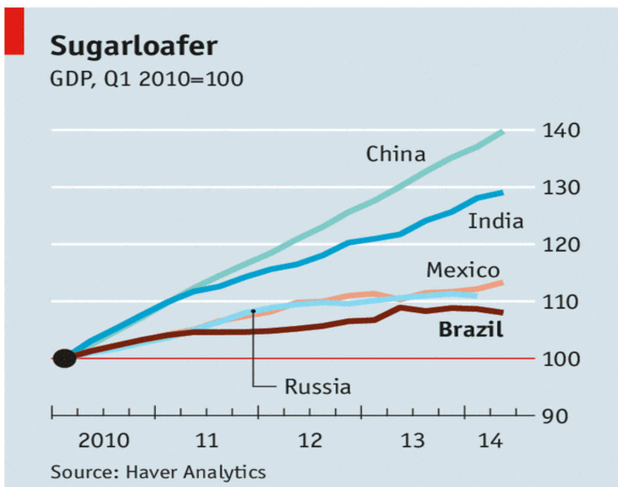
- Overall slowing growth in the economy and stock and bond markets
- All US Markets are affected by this stall/decline
    - May be entering a bearish period
- Should avoid any companies with strong connections to Euro Market



EUR/USD

b. Emerging Markets (BRICS)

c.

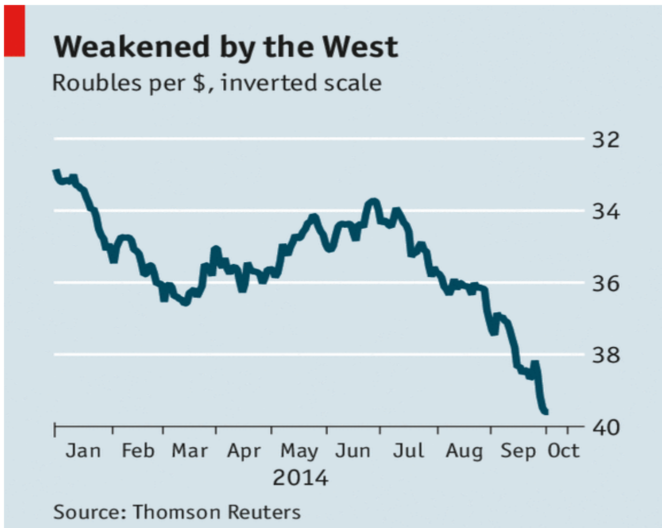


Russia

- National security has become "a universal way to push through all sorts of stupidity", says Tatiana Lysova, *Vedomosti's* editor
- Unrealistically optimistic budget passed recently- Russia is unwilling to face the truth
- Economy traditionally focused around oil and gas production.
- Putin afraid to encourage innovation- could lead to a political threat
- Putin platform based on blaming west for problems
- Annexation of Crimea and Ukrainian war was a gamble to strengthen his political base
- Backfire- sanctions from the West
- Firms having difficulty in finding financing

Rouble performance

- Global firms like Blackstone and Adobe leaving Russia
- Foreign owned media soon to be ousted, i.e. Forbes-Russia
- Growth is reducing: Stagnation is best case scenario
- Reduction in oil prices
- Decline will continue to spill over into Germany and perhaps France
- Eurozone will be pulled down with Russia
- Avoid firms tied to Russia



Brazil:

- Declining growth and lower growth forecasts
- Entering into a recession
- State mandated holidays during world cup reduced output significantly
- Protests over lack of public transport and general discontent
- Very competitive election ahead
- Low level of investment

South Africa: Biggest trade partner is Russia

China: Economy is slowing down:

- The government is showing some effort to boost economic growth with interest rate policies.
- It is important to note that China is losing its comparative advantages to other countries like the ASEANS as it moves up the production chain.

- The real estate market bubble in China is forecasted to burst, and also to impact the banking sector. Foreign investment in these sectors would be affected.
- Growing inventory, sluggish prices, decreasing floor ratio can also impact construction industry in China.
- China's growing consumerism culture provides opportunities for TNCs due to their large market pool.
- Hong Kong protests have impacted China's economy negatively in the short run; this impact can still spill over in the long run.
- China is currently in dispute with many other countries with regard to marine territories - such as Japan, Vietnam, Philippines, etc. which can impact the country's industries as China now imports much of their raw materials.

BSIF Sectors Fall 2014

a. Consumer Defensive

Overall

This is a wide category with several sub-sectors, but there are some general notes to make about the sector as a whole. First, most of the industries are highly competitive, making it difficult to find a variety of firms that operate on the size that BSIF requires. Second, it's good to keep in mind that even though defensives react less than other investments to changes in discretionary income, they do still react. In fact, going by average beta values, only restaurants, food processing, and retail are technically "defensive."

Recent drops in unemployment are good news for the sector overall, but are not the whole story. Manufacturing output is up, but consumer durables took a considerable hit in Q3. The ISM's September *Report On Business* shows continued growth in the Purchasing Managers Index and several other key indices, most of which have been growing since the beginning of the year. This indicates, as mentioned above, that we are nearing the top of the business cycle and all consumer goods may be due to take a hit in the near future. But on the whole, consumers are more optimistic now than they've been in years, geopolitical concerns notwithstanding.

Food and Beverage

In the food and beverage industries, the major trend is one towards healthier eating. The packaged food industry is being confronted with increasing demand for more transparency, but despite vocal resistance, GMOs aren't going to go away and there are no initiatives on the horizon to require labeling in the US. Organic foods remain one of the fastest-growing parts of the industry. Since 2013, soda sales have been slipping over health concerns; research in artificial sweeteners and alternative formulations are seeing a boost as a result. In contrast, snack foods have seen a major increase (between 3 and 10%, depending on the market) in consumption in the last two years. Restaurants of all types are posting year-to-year revenue gains, with fast-casual chains like Chipotle gaining popularity in the market.

Housewares, Appliances, and Electronics
The housewares, appliances, and electronics industries are expecting to experience growth between 2013 and 2018 due to improving disposable incomes in addition to the technological advances in TVs, PCs, and appliances that will encourage consumers to upgrade from older models. These advances in technology are more applicable to some goods than others, but few have gone without any improvements. Also of note is that electronics manufacture is in the midst of "re-shoring" trend, bringing production back to domestic sources.

Textiles and Apparel
In the world of textiles and apparel, pent-up demand has led to year-to-year increases in revenue since 2009. IBISWorld research anticipates a 4.7% revenue growth for 2014, continuing through 2018 in the textile industry. The lion's share of these gains will accrue to China & Vietnam, which continue to dominate apparel imports in the US. Domestic manufacturers might be losing out, but consumers stand to gain: clothing is now less expensive than ever both in inflation-adjusted prices and as a share of disposable income.

Retail
Both of the above industries are tied to the retail industry, whose future will be tied to the rise of the internet. Firms that integrate successfully into the online economy will see gains over those that do not. As evidenced by the growth of Wal-Mart, Target, and Carrefour, the trend towards centralizing where shoppers go in person continues, even as they diversify their shopping sources online.

b. Basic Materials / Utilities

- The basic Materials/ Utilities are seeing potential growth in revenue in the short run due to low oil and petroleum prices. However, energy sectors are facing the threat of a declining value due to a surging supply of petroleum goods.
- Unpredicted changes in price will take place in November when OPEC will meet to decide upon lowering output to boost price.
- National electricity retail price increased by 3% on average
- Gasoline use has also risen by 1.6% over the past 10 months.
- All favors steady growth of utilities; stocks of this industry can be invested in as defensive stocks with moderate growth potential. However, changes towardsn

green energy approaches must be closely watched as it is becoming more and more important.

- Other event such as the Russia – Ukraine and South Chinese Sea dispute can have an impact on petroleum output as they are big suppliers other than OPEC.

c. Pharmaceuticals

According to research by PricewaterhouseCoopers, seven major trends are shaping the pharma marketplace:

- Instances of chronic disease are increasing, placing even greater pressure on already stretched healthcare budgets
- Healthcare policy-makers and payers are increasingly mandating what doctors can prescribe
- A growing number of healthcare payers are measuring the pharmacoeconomic performance of different medicines. A widespread use of electronic medical records will give them the data they need to insist on outcomes-based pricing
- Boundaries between different forms of healthcare are blurring, as clinical advances render previously fatal diseases chronic and the self-medication sector expands
- Demand for medicines is growing more rapidly in the emerging economies than the industrialized economies [American firms still have a relatively small presence there-- first one to establish a good reputation stands to make great gains]
- Governments are beginning to focus on prevention rather than treatment, although they have not yet invested very much in pre-emptive measures
- Regulators are becoming more cautious about approving truly innovative medicines.

There are a few upside-downside tensions whose balance will affect the industry as a whole. First, technology improvements are leading to faster results from research. The rate of "science per day" is going up. However, firms are facing higher R&D costs and decreasing marginal returns to the research that is getting done. So even though more is being accomplished, it is costing more and paying out less than it did, on average.

Second, with the expansion of medical provision in the US and increasing incomes in the developing economies, demand for medical goods and services of all types is increasing. With increased demand, however, comes increased scrutiny. Healthcare has been highly politicized of late and tighter regulation means firms are facing increased compliance costs. This will inevitably mean higher costs for consumers (demand growing faster than supply)

This plays into the third tension, that between more liberalized trade and the generally harder market conditions that pharma companies are facing. The research-heavy firms are facing an estimated $18 billion loss to “generic erosion” this year alone, with an estimated $148 billion total loss through 2020. That is, as patents expire, manufacturers of generic drugs will be flooding the market with cheaper alternatives.

Changes are taking place in healthcare culture as well. Pharma companies are starting to face consumers who demand zero sum: if you raise costs in one area, you have to cut them in another. Buyers of all kinds-- hospitals, clinics, and patients-- are demanding greater value and demonstrating an unwillingness to “pay more to get more.” Successful companies in the near future will be focusing on providing greater value to their customers while holding prices down.

As costs continue to rise, patients and doctors will increasingly focus on prevention rather than treatment. This is hard to monetize and in the future will make returns harder to come by. In the meantime, however, there is no cure for aging, and as the Baby Boomers get older, incomes for pharma and healthcare providers will continue to increase.

The internet is becoming a larger force in healthcare. Patients are better informed about their treatments and prescriptions and have more venues for discussion about effectiveness. Doctors as well are using it to communicate with patients. Every prescription written generates massive amounts of data that can be mined for trends. Companies should be capitalizing on this trend and providing value and services through the internet, as well as focusing on integrated data management.

While there is high growth potential in the developing world, the time frame for it is beyond most of our college careers. The companies that derive the most income from sources other than the US, Europe, and Japan still only derive less than a third of their gross income from BRIC and tertiary markets. This facet of the sector has to be highly reactive to the rapid pace of the developing world, and the uncertainty that creates makes long-term planning difficult. The dominance of American firms in these markets is also highly contingent on rapidly-changing political and social perceptions.

According to the Commerce Department, biologics, OTC, and generics are the most promising domestic growth sectors.

d. Financials

- Banks are in a time of transition and are being charged large fines for their role in the recession

- No longer allowed to speculate on their own account
- Fixed income investing has not been very profitable
- Due to the low interest rate environment banks are not making a lot of money so in order to generate earnings growth banks are cutting costs (reduction of staff etc.).
- US Government is still trying to deal with the “Too big to fail” risk; they have implement Basel III and all banks are complying with this.
- Inherently tied to Fed activity and interest rate hikes; if rates go up bonds and lending will become more profitable. This is a good time for BSIF to enter into the sector.

e. Old tech

- Big tech firms are acquiring small companies to maintain competitiveness. And the Cloud is now the new source of growth for Old Tech and companies like Microsoft, Oracle, Intel and IBM are pushing into this space.
- Old Tech companies are trying to revive themselves by splitting their business in order to unlock shareholder value and to increase profits through diversification of products.

Conclusion

The US economy holds its ground while international economies are showing signs of trouble. Overall, volatility remains high. The Federal Reserve will not raise interest rates in the near term; we expect a rate hike in December 2015 or earliest Q3 2015. Economic indicators overall show positive growth. Caution is required when investing in companies with strong ties to China due to rising uncertainties and a potential economic slowdown. Europe remains in a state of uncertainty as its economy slides backwards in fear of deflation and indecisiveness.