# ECONOMIC REPORT

**OF THE**

# INVESTMENT ENVIRONMENT COMMITTEE

BSIF STUDENT INVESTORS

TRANSMITTED TO THE FUND
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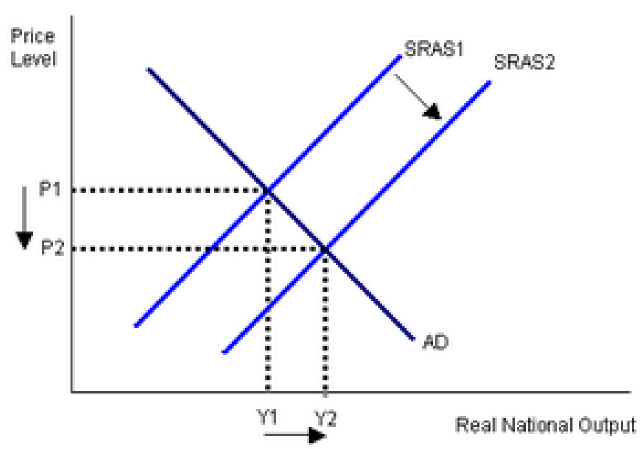
## STATEMENT OF PURPOSE

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.

## INTRODUCTION

The United States is still the strongest supporting pillar of the current global economy. Even though last year's growth was with 2.6% below expectations, it builds on the 2.5% growth from 2013. Compared to stagnation and even (temporary) recessions in other developed countries, such growth rates are exceptional. The United States currently exhibit a period of economic expansion and falling inflation ("expansionary disinflation") which may continue if oil prices remain low, supporting a "positive supply shock" as shown in the graph below. Despite a mostly positive national outlook, soft commodity prices, persistently low interest rates together with increasingly divergent monetary policies across the most important global economies, and weaker world trade lead to rather worrisome to mildly optimistic global economic outlook. Both the IMF and World Bank reduced their global outlook again in recent months. For 2015, the IMF and World Bank expect global growth rate between 3% and 3.5%. In addition, the IMF advised advanced economies to maintain accommodative monetary policies to avoid increasing real interest rates as cheaper oil heightens the risk of deflation.

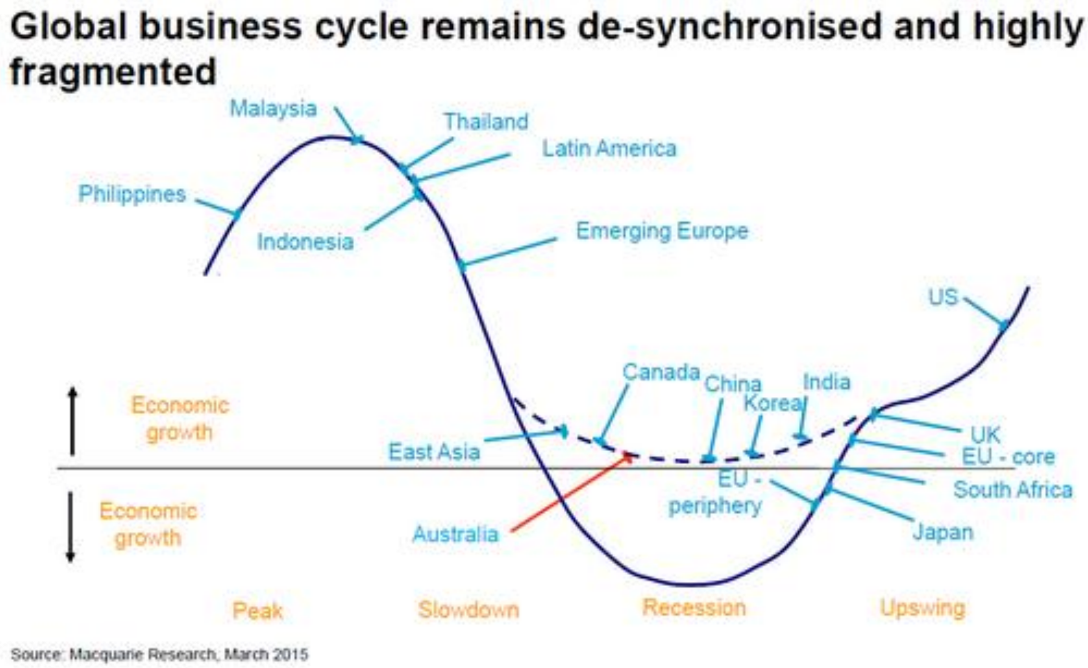



Source: Forbes

## HEADWINDS

Current areas for concern include domestic politics. The US Congress approval ratings remain extremely low with 75% of the people questioned in the March Gallup poll disapproving of Congress. At the same time, the stalemate between the Republican controlled Congress and President Obama is also not beneficial for the US economy. Blocking and vetoing bills as well as blackmailing each other are dangerous plays. Just recently, the US barely avoided a partial government shutdown. Going forward, these problems are likely to reignite during the next budget discussions.

Internationally, we see a greater divergence. While the US and UK economies are recovering, developing economies aim to achieve greater macroeconomic stability. At a point where the US ended quantitative easing and considers increasing interests rates, Europe started quantitative-easing program just last week, adding lots of public debt to the private-sector bonds it has already been buying. Europe's troubling state caused the Euro to tumble. This year alone, it lost 13%, reaching a 12-year low. However, the cheaper euro will make Europe more competitive, boosting growth-inducing exports and causing capital to flow back into the area. On the other hand, also Asia is showing signs of concern. China has cut interest rates for the second time in three months, and also Japan is holding on to its massive stimulus program.

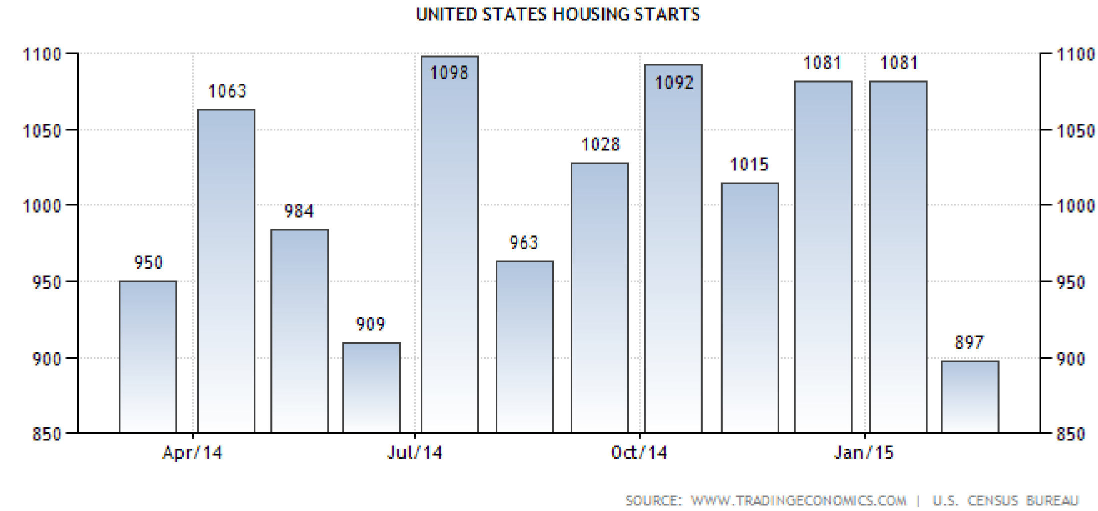


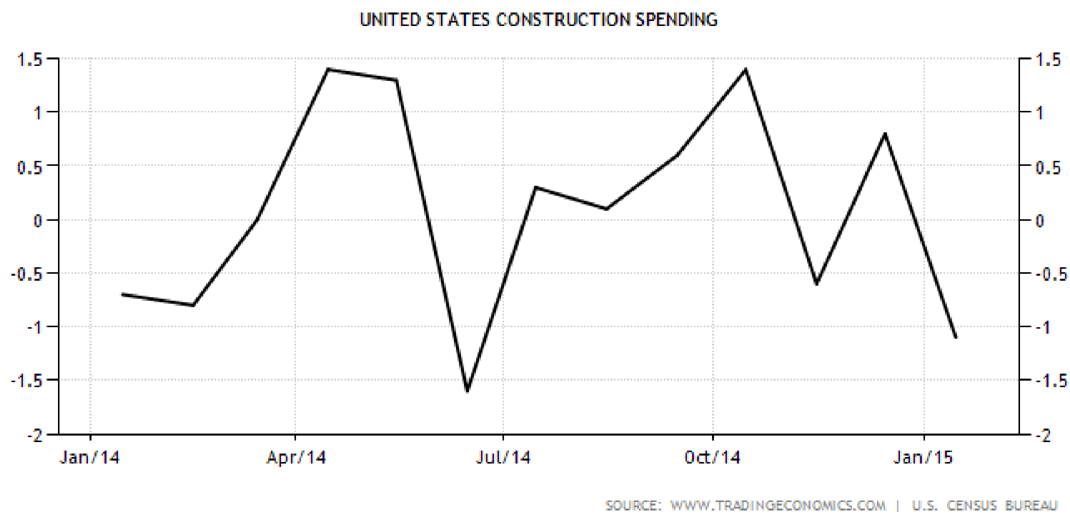
# Domestic Economic Data And Trends

## Employment


Since the last recession, there has been a consistent improvement in the amount of jobs created, thus it has also lead to a stable decrease in the Unemployment Rate. The Unemployment Rate currently sits at 5.5%, the lowest since the last recession of 2008. During last month's period, a total of 295,000 jobs were created, beating expert expectations of 240,000 jobs. Despite a strong jobs report, the Labor Force Participation Rate is still at a 30 year all-time low of 62.8%. Given the combined information, even though a strong Jobs Report is produced; the Labor Force Participation Rate is still low, therefore prompting the Federal Reserve to be cautious about raising interest rate. However, there are others that conclude that the Federal Reserve may raise interest rate as soon as June.

## HOUSING



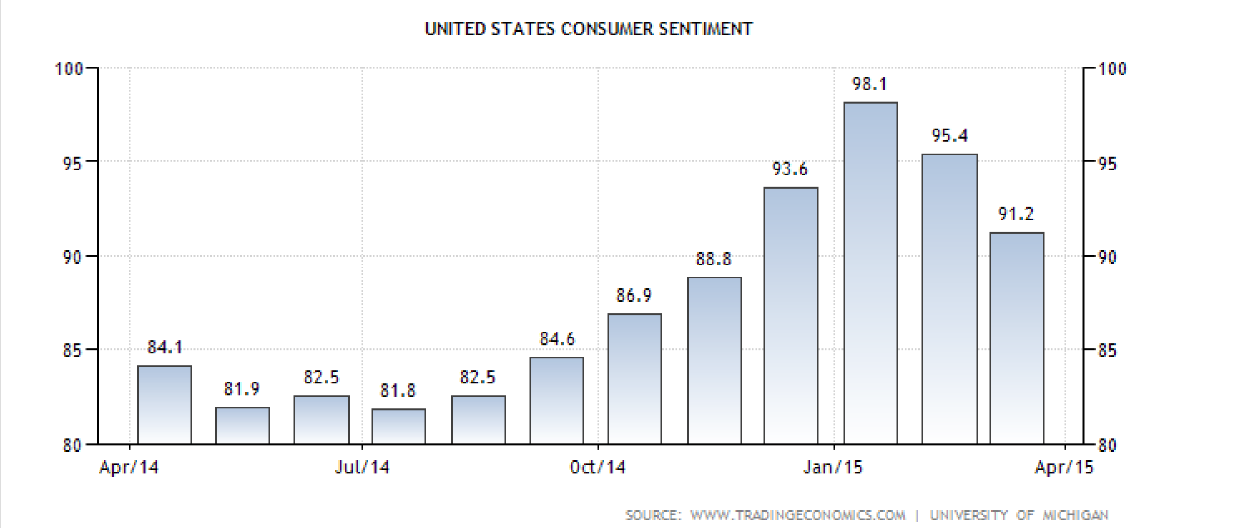




Housing Starts together with Construction Spending has been sluggish and highly volatile. Housing Starts declined 17% from 1.081 million to 0.897 million falling way short of expectations of 1.04 million, suggesting that student debt, harsher winters, tighter credit condition and rising prices might have prevented first time buyers from entering the market. However, at the same time a stronger labor market may support the building of rental units. Housing Starts in the Northeast shrank the most by 56.5%, followed by rhw Midwest (-37%), West (-18.7%) and the South (-2.5%). Followed by the disappointing results of the February Housing Starts, the decrease of 1.3% in mortgage applications did not help either. This puts around 5.4 million homes in negative equity position, in other words owners owe more on their mortgage than the house is currently worth.

Construction Spending fell by 1.1%, from 982 Billion to 971.4 Billion. Components that make up the construction spending consist of the Private Construction and Public Construction. 70% of all Construction Spending is accounted for by the Private Construction and it fell by 0.5% from 700.9 Billion to 697.6 Billion. Public Construction on the other hand fell 2.6% from 281.1 Billion to 273.8 Billion.

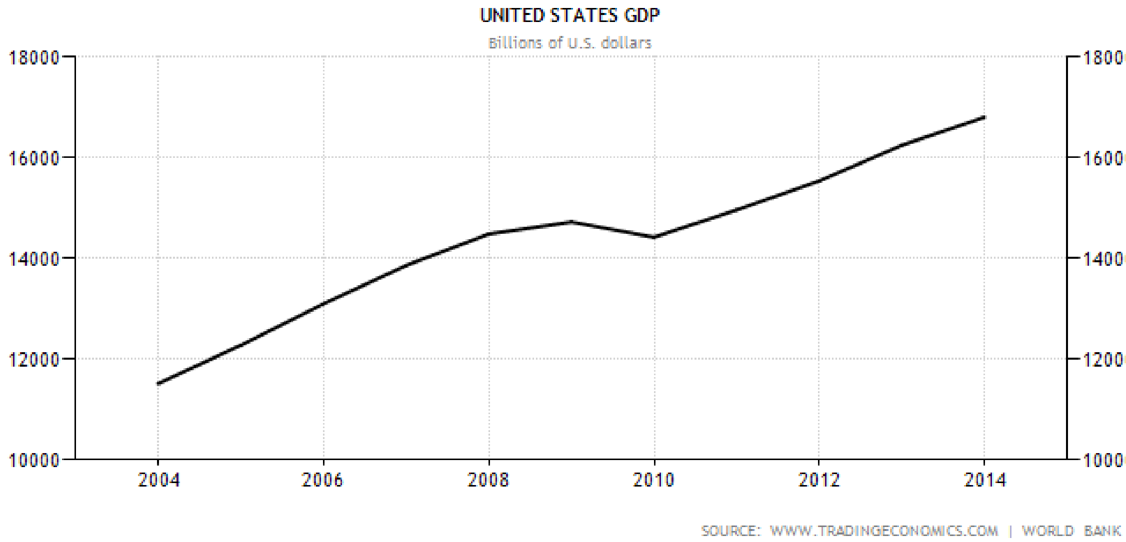
Overall, given the combined forces that act in the housing market, our expectation towards the housing market is still sluggish and volatile.

## CONSUMER SENTIMENT




Consumer Sentiment is a crucial indicator of the United States Economy because its economy is consumer driven. Consumer Sentiment reached an 11 year all time high of 98.1 on January, but fell to 91.2 in March. The further decline in Consumer Sentiment might be due to harsher winters, higher utility cost and income decline in United States. Although a lower Consumer Sentiment, joined by an increase in consumer spending, we believe it is still likely to support a 3% GDP growth rate. A rebound in Consumer Sentiment is likely Because United States is mostly consumer driven.

## GDP




GDP has been slowly increasing since the 2008 financial crisis due to low interest rates and Quantitative Easing. Fueled by stronger consumer spending due to lower oil prices, the GDP growth rate is expected to hit 3.1%-3.4% from the current growth rate of 2.4%. Q4 was a disappointment as it only stood at a growth of 2.6% as opposed to Q3 of 5%. We expect this slowdown to be short-lived given the strong response from lower gasoline prices. Given the strengthening of the dollar, we can expect it to hurt overseas sales but we believe the fundamentals of the United States economy can cushion the weakening overseas economy.

## Currencies

Currencies have become an interesting area like Oil, and the strong U.S dollar has been a help for overseas markets. This has a negative impact for U.S exports because of the strong dollar and an interest rate hike will cause cross roads between currencies with a looming currency war in the near term future in the near term. The Euro will have parity with the dollar in the near term with some analysts predicting $1 will be worth 0.85Euros. The third most important central bank, Bank of Japan has been significantly stimulating the economy and weakening their currency with a QE program of 80 trillion yen. We see the Yen: Dollar reaching $1: 135-140Yen.

Trends

- We can expect Wages to improve after years of stagnation
- Expect Rate hike this year

## FEDERAL RESERVE BANK

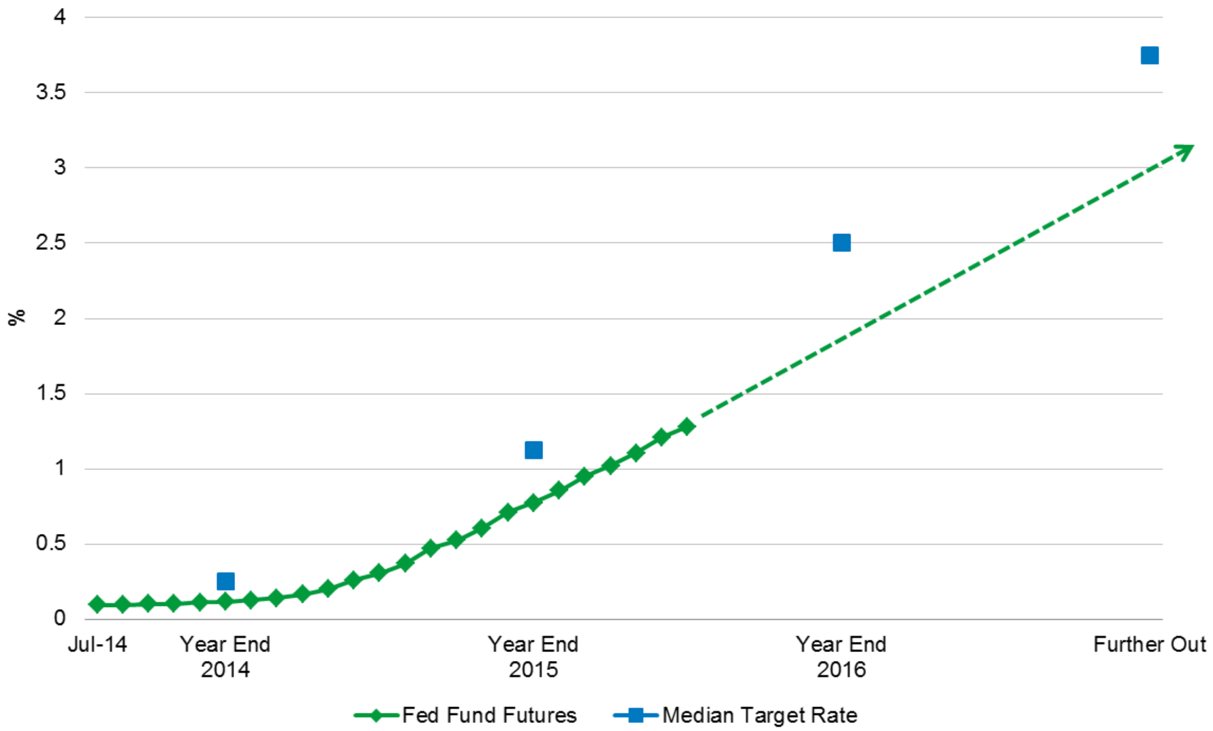
The recent FOMC minutes that came out on January 28 indicated that the Fed is still cautious on raising interest rates and that they are still remaining data dependent. The FOMC minutes still kept the word "patient" in their text but however the outlook for higher inflation and lower unemployment coupled with the good jobs reports from the past 6 months suggests the Fed will stick to plans to raise interest rates this year for the first time since 2006. We anticipate a rate hike in Q3 2015 around the September meeting. There is a lot of chatter that the Fed would raise rates in June 2015 but this will likely not take place given 2014 Q4 GDP came in at +2.6% which was below the expected target of 3.0%. Given all this mixed data a rate increase is unlikely in the first half of 2015 and even looking at the second half of 2015 a rate increase will only take place if the following conditions prevail:

- If the target inflation rate hits 2%
- If the slack in the labor market tightens (still not enough participants in the market)
- Wage growth

The majority of the FOMC thinks the drop in oil prices is a net gain for consumers as they will use the money saved at the pump to spend more. In their FOMC minutes, the Fed said "recent declines in energy prices have boosted household purchasing power." Overall Janet Yellen will not rush in raising rates which might be bad for the financial sector as they need higher interest rates to really drive earnings growth but we see credit card companies like MasterCard, Visa and Capital One getting a boost because of the fueled and high consumer confidence from the savings in gas. To sum up, Yellen will remain dovish given the current economic conditions and a hint of this was shown with her testimony to Congress that the central bank is pleased with recent economic growth but convinced there is room for improvement and still pondering when to start raising interest rates. A quote from her latest testimony to Congress states:

> *"There has been important progress, however despite this improvement, too many Americans remain unemployed or underemployed, wage growth is still sluggish and inflation remains well below our longer-run objective."* (New York Times, 2015)

The recent unemployment number of 295000 has added a twist to the Federal Reserve interest rate decision with many analysts thinking that after the FOMC meeting on March 18, Janet Yellen will drop the word "patient" and an interest rate hike will be coming in June 2015. However with the strong U.S dollar and the recent weak factor data and poor housing number we are fearful of a rate hike in June 2015 as that will hurt the markets and coupled with the strong dollar this will have a significant impact on a lot of U.S companies that have international exposure and that will hurt their profits.




(BlackRock)

## FEDERAL RESERVE BANK STRESS TESTS

Due to the financial crisis of 2008, there has been an increased regulation in the form of the Dodd Frank Act on the financial sector. Also another form of these various regulations has been the Federal Reserve Bank Stress tests under the Basel Capital Measurement which evaluate the capital structure of banks and financial institutions. These Federal Reserve Bank Stress tests evaluate the financial soundness of major financial institutions and they evaluate whether banks can give back money to shareholders in the form of dividends or if a bank can buy back its stock to increase its value.

From the recent Federal Reserve Bank stress tests, the Fed gave favorable marks to the 31/31 banks that underwent its first round of annual stress tests, marking the first time every bank has met the minimum capital levels since the test was introduced in 2009. For the second round 28/31 banks were approved to declare a dividend and all three of our holdings PNC

Financial, Wells Fargo and Capital One Financial passed. Due to successful Fed Reserve stress tests, PNC increased its dividend by 6.3% to $0.51/share and announced a $2.8Billion stock buyback program. Wells Fargo increased their dividend by 7% to $0.375/share and launched a $3.1Billion share buyback program. Capital One increased their dividend by 33.3% to $0.40/share and announced a $3.125Billion stock buyback program.

# SECTOR OUTLOOKS

## ENERGY

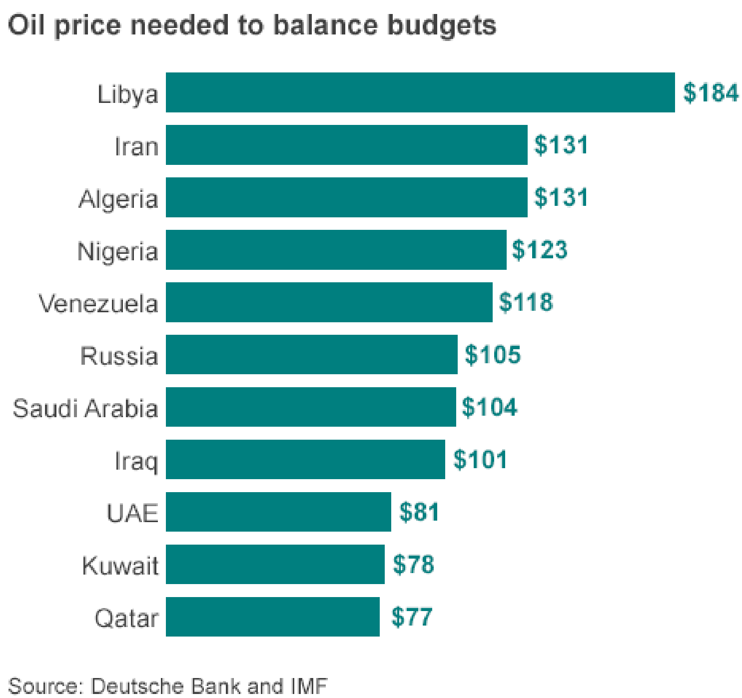
### OIL

Oil prices have fallen to the lowest price in the decade due to weak demand in many countries, and due to stagnating or decreasing economic growth, coupled with surging US production. The number of rigs actively drilling for crude in the U.S. is down by 25% since October. In addition, the Energy Information Administration (EIA) forecasts that Brent crude oil prices will average $58/bbl. in 2015 and $75/bbl. in 2016. In the long-run, low oil prices will inevitably reduce production and increase demand, which will eventually rebalance the market and enable oil prices to recover. However, analysts think this process may take up to two to three years. In addition, many rigs are currently a sunk cost for oil companies, which simply try to make as much money out of them as possible. With storage capacities at their maximum and demand for oil in the U.S. being lower in the spring as refineries switch over from producing home heating oil to summer blend gasoline, this could provide a good opportunity to add to positions affected by low-oil prices. In the long-term, global oil demand is likely to rise a bit faster than projections after failing to meet projections last year. The International Energy Agency (IEA) raised its demand forecast for the second half of this year by 75,000 barrels.

On an important note, oil prices just reach a new low on Tuesday when the American Petroleum Institute (API) release their report on a surge in crude oil supply of 10.5 million barrels. Currently, stored supply of crude oil is at an 80 year high. Moreover, oil prices are expected to continue to drop when the IEA releases their new report on Wednesday, March 18 as suppliers would be force to sell oil when their storage capacities are exceeded.

### GLOBAL IMPACTS

Low oil prices have significant geopolitical and global implications. Venezuela, one of the largest oil exporters, has already had trouble balancing its budget when prices were high. If oil prices remain low, this means serious trouble, adding to the already extreme inflation of approximately 60%. Similarly, Russia's economy would shrink by at least 0.7% in 2015. Another important player is China which is on track to becoming the largest net importer of oil. China will gain in the short-run from low oil prices. Nevertheless, this is unlikely to offset the headwinds the country faces in terms of slowing economy. Similar to China, India imports 75% of its oil, and analysts say falling oil prices will ease its current account deficit. Lastly, also Japan imports almost all of the oil it uses. Since high oil prices helped to push inflation higher, lower prices may increase the country's deflation and add to the existing stagnation.




## INDUSTRY IMPACT

Companies with high transportation costs and of course transportation providers such as UPS and Norfolk Southern will benefit the most from lower oil prices. Also processed food manufacturers who spend between 10-15% of their costs of goods on freight and fuel will come out ahead.

In contrast, oil exploration and production and oilfield services sectors are expect to suffer immensely. These consequences can be felt through the supply chain. For instance, Caterpillar will face the risk of order cancellations and deferrals as oil companies put off investments. Similarly, suppliers of fuel-efficient aircraft and their components might suffer since their products' fuel efficiency becomes less appealing amidst low oil prices.

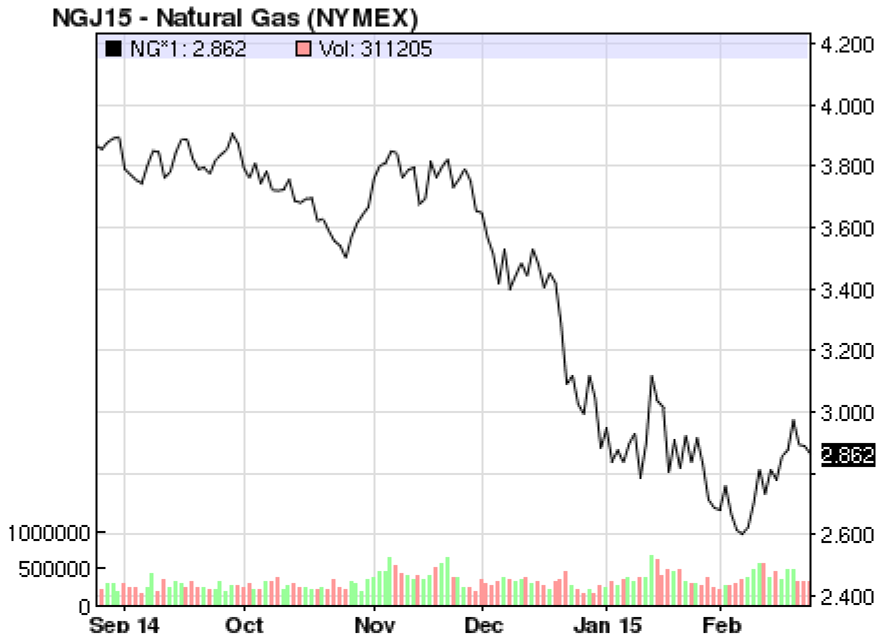
Low oil prices may lead to shift toward larger, higher-margin vehicles such as SUVs at the expense of smaller, more fuel-efficient models which may moderately benefit US car manufacturers. Sales should improve especially for companies including General Motors and Ford.

U.S. consumers are expected to save $200 billion in energy costs, which equals 2% of consumer spending. To put this into perspective, these savings are comparable to one fourth of the $800 billion stimulus spending program of 2009 during the last recession. Going forward, retailers, restaurant chains, cruise lines, and resorts may potentially benefit from consumers having larger discretionary budgets.

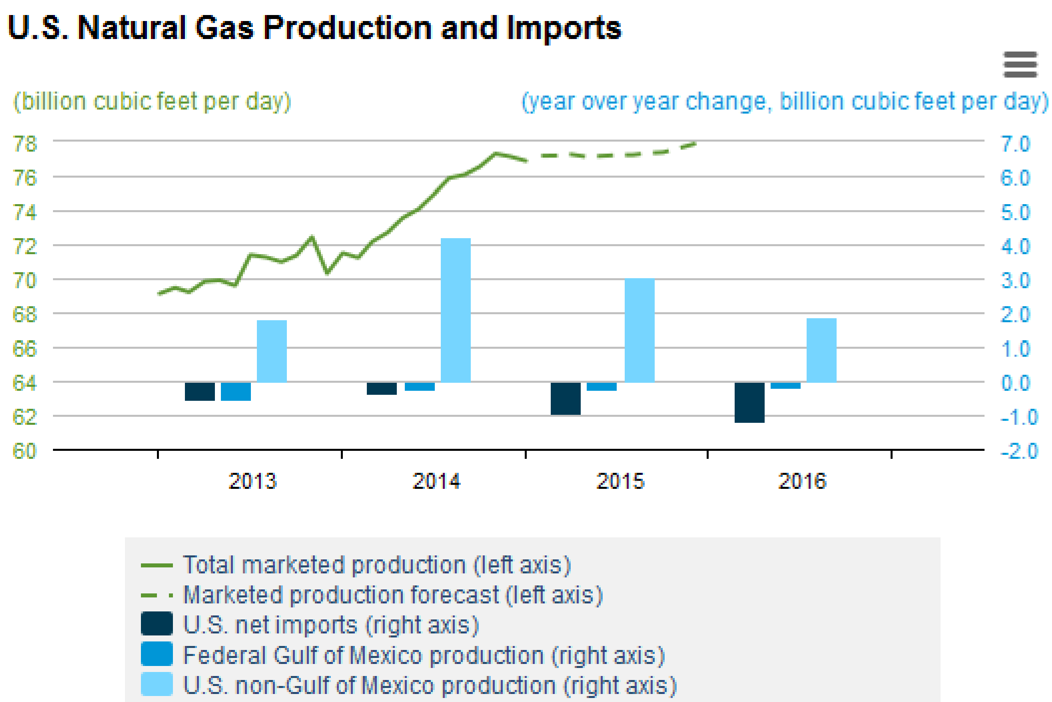
## NATURAL GAS

The nationwide transition from coal to natural gas has been going on for some time. The move to natural gas is gaining momentum and several coal-dominant regions of the country have already reached usage equilibrium with gas. Experts predict by 2020, at least one-third of the U.S. generating capacity derived from coal will have been retired with the vast majority of that being replaced by natural gas. Increases in domestic natural gas production are expected to contribute to lower demand for natural gas imports from Canada and increasing exports to Mexico. The EIA expects exports to Mexico, particularly from the Eagle Ford Shale in South Texas, to increase because of growing demand from Mexico's electric power sector, coupled with flat Mexican natural gas production. Natural gas prices are highly correlated with oil prices and are also dependent on weather as half of U.S. homes use natural gas. Going into the summer, adding a holding in an internationally-exposed natural gas company as an effective play on macroeconomic and seasonal trends. In contrast, Spectra Energy which is only exposed to the domestic gas market may face headwinds in the short-term future.

US Average Gas Prices



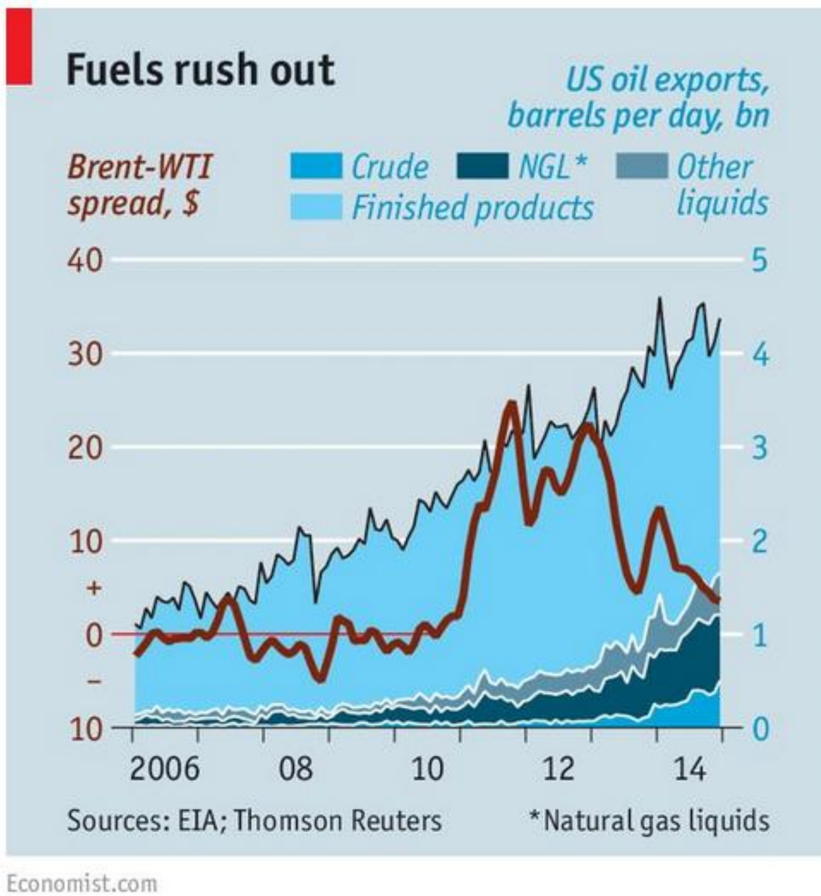

Source: NASDAQ




Source: EIA

## ENERGY EXPORTS AND LIBERALIZATION

The United States is in the process of entering an era of more extensive energy exports. The oil export ban was put in place in the wake of the 1970s Arab oil embargo, to protect Americans from gasoline shortages and price spikes, is now outdated. Oil companies and energy economists push for change. This is supported by its trade partners, especially the European Union. Most of its members are largely dependent on Russian energy exports. US crude energy exports could make America richer, increase the bargaining power of its allies stronger while decreasing the power of energy monopolies. Already right now, American waterborne LPG (liquefied natural gas) exports have overtaken those of many big Arab producers and are expected to surpass Qatar to become the world's largest by 2020. Overall, there is a big switch in America’s energy industry with new LPG terminals being built in Texas ready to export LPG.

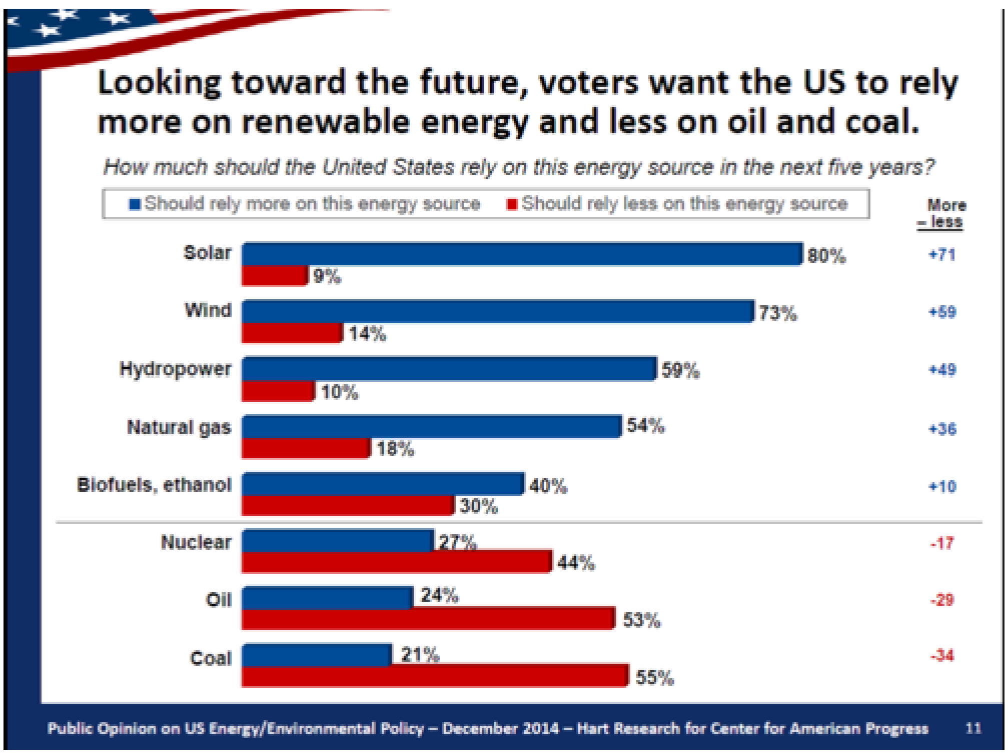


## KEYSTONE: IT MAY BE OVERRATED

The Keystone Pipeline has received disproportionate national attention and is overrated in both politics and the media according to The Economist. The news magazine claims that Republicans like using it to demonstrate how President Obama has failed to create jobs without upsetting anyone within their coalition. At the same time, President Obama can use Keystone to appease environmentalists in his party. Altogether, Keystone is neither as bad Democrats claim it is nor as beneficial and crucial as Republicans make the public believe.

## OTHER NOTES ON ENERGY

The coal sector is slowly collapsing and jobs are cut. Even though the Republican Congress may be a wild card but American people do want change as supported by the survey below. Also coal consumption in China is expected to peak in 2020. China's awakening on the climate challenge signals a continuation of the upward trajectory of its investments in renewables, and a potentially catastrophic loss for US and Australian coal exporters.



## UTILITIES

Utilities are a sstable defensive investment, generating consistent cash flow and paying nice dividends. People need electricity, water, and gas no matter the current economic climate. However, the downside of utility companies is their sensitivity to interest rate hikes. With their high debt loads and capital expenditures, as interest rates rise or drop, the debt payments will increase or decrease. Thus, this sector performs best when interest rates are falling or remain low.

Even though interest hikes are a good entry point, we may be early to the game. Once interest rates have been increased by a substantial amount and we near the peak of the business cycle, it may be ideal to purchase a utility company.

## BASIC MATERIALS

Lastly, we would like to provide some background about the basic materials and utilities sector to help with selection of and voting on companies in this sector.

The basic materials sector refers to mining and refining of metals, chemical producers, and forestry products. It is important to realize that Macroeconomic factors have great impacts on the industry. The macroeconomic climate impacts demand and therefore prices of raw materials. It is important to consider driving commodity prices and the possible correlation with oil prices. In addition, low interest rates facilitate financing capital-intensive projects such as processing plants and new explorations. Also currencies have a large impact on this sector since most materials are produced or mined in foreign countries. Overall, the basic materials industry relies on a healthy global manufacturing economy for its success, thus it is important to consider the global business cycle when researching potential investments.

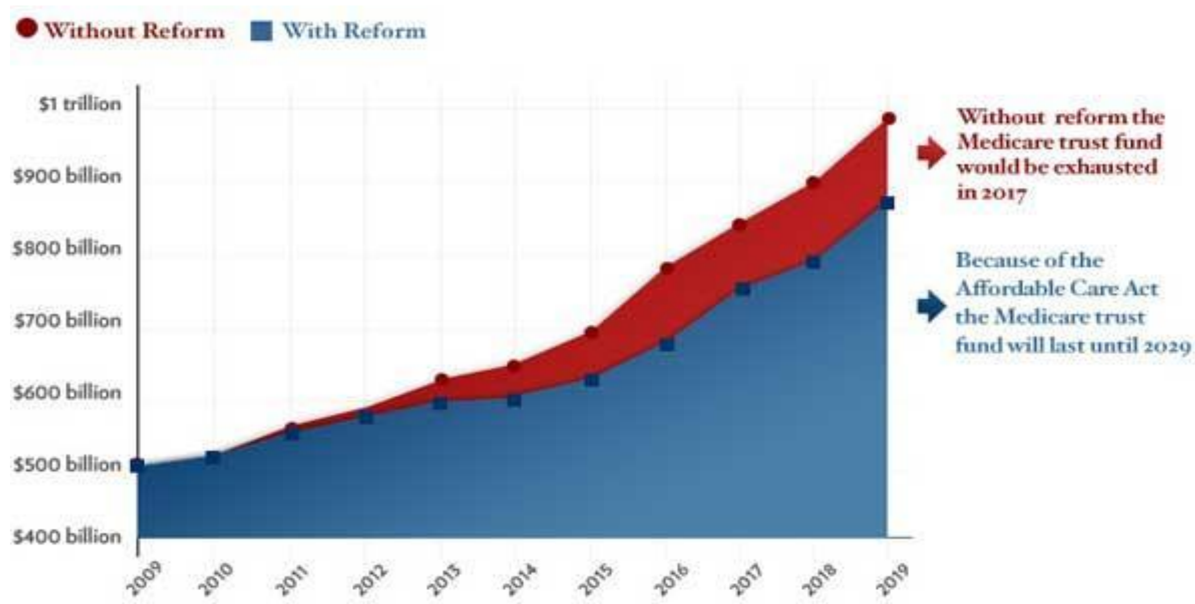
We recommend looking at an international company as international demand will be fueled by economic stimuli abroad and easy monetary policy. However, it is crucial to assess the specific currency and macroeconomic exposure of individual companies.

## HEALTHCARE

The Healthcare sector has been one of the strongest sectors over the past three years and still looks like the place to invest for 2015. In terms of Obamacare also known as the Affordable Care Act has had a tremendous impact in the healthcare and has boosted some of our holdings like Select Medical (SEM) and Medtronic (MDT)**.** Obamacare's impact can also be seen in the wider profit margins that hospital chains have reported. Because the law is designed to contain costs as well as give insurance to more people, hospitals and other health-care providers are merging to build up scale. In 2015, the industry is looking to add as many as 5 million newly-insured customers through the Obamacare exchanges, relying on projections by the Congressional Budget Office. In addition to providing coverage to a wider group, Obamacare has the potential to incentivize Healthcare providers to give better care by rewarding them for successful procedures, rather than reimbursing them for all costs, as has been done previously. But the most important prize may be delivered if more states choose to use federal money available under the law to expand state-run Medicaid programs. However states have been resisting this move of expanding state-run Medicaid programs. Another area which has brought the spotlight back on Obamacare is the fact that we now have a Republican Congress who has threatened to repeal the Affordable Care Act we do not anticipate this will go far as the President will just veto the bill. A quote that supports this stance states:

> *"Talk of repealing the Affordable Care Act is like talk of repealing the interstate highway system," -Timothy Jost, health care law expert*

Looking at worst case scenario, if Congress repealed Obamacare it would cause havoc in the healthcare market many people would immediately lose coverage because they could no longer afford it. Others could be kicked off their plans without Obamacare's protections for people with preexisting conditions. The amount of health care costs would skyrocket and basically you would have a lot of people die because they couldn't get health care. In terms of the sector this will result in health care stocks losing earnings power as the volume of people paying for health care would drastically drop as government subsidies are cut on hospitals and healthcare insurance players. Without an individual mandate and without subsidies to make insurance affordable, younger, healthier people would likely drop their coverage, leaving insurers to cover older, sicker people with more health care needs. But insurance companies can't raise premiums until next year because the 2015 rates have already been locked in—at the very least; it would take months to negotiate rates with each state. Obamacare getting repealed will not take place due to the drastic effects it can cause in the healthcare market.



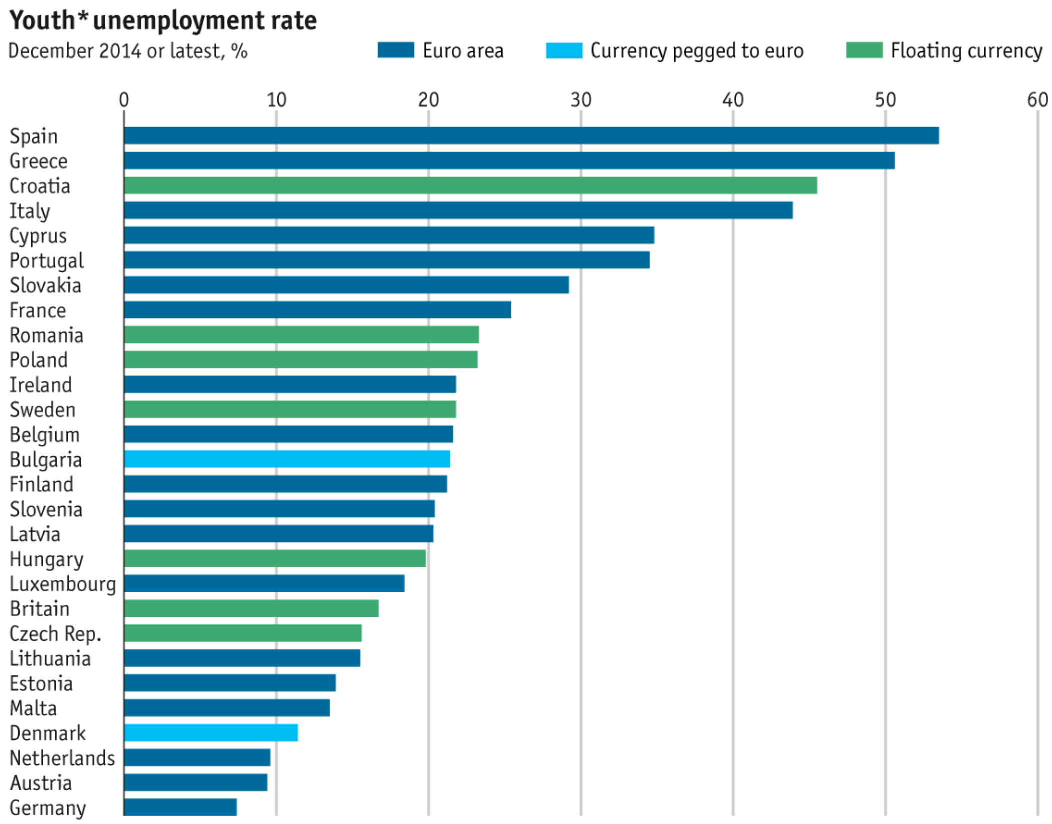

(Marketwatch)

The sector overall looks relatively strong and we see it expanding even further with biotech companies like Gilead, Regeneron, Celgene and Biogen leading the charge. Hospital stocks like Select Medical will grow in earnings as coverage increases, drug makers like Pfizer, Eli Lilly will be looking for growth which will likely result in some M&A activity and this is aided by the low interest rates and easy money from the Fed.

## Global Climate

### Europe

Europe is far behind the US in terms of economic recovery. Unemployment rates of over 10% are not uncommon in many European States. Even more concerning is youth unemployment, which is greater than 50% in Spain and Greece, and over 30% in Portugal, Cyprus, Italy, and Croatia.




Deflation is becoming a serious concern in the region, which has spurred the European Central Bank (ECB) to engage in a Quantitative Easing program amounting to 60 Billion Euros of month. Months before, the Federal Reserve ended its own Quantitative Easing program, suggesting an impending US interest rate hike in 2015. In terms of monetary policy, the ECB and the Fed look to be on opposite paths. This will negatively affect the value of the Euro in terms of US Dollars, which recently hit a 12 year low. A higher US interest rate (relative to Europe's) increases the return on domestic securities (relative to foreign securities). These higher returns drive foreign investors to buy US securities, which they must purchase with Dollars. This increases the demand for Dollars which translates into an increase in the price of the Dollar (decrease in the price of the Euro). A pricey Dollar makes foreign goods seem relatively cheap, which increases imports to the US. Conversely, this also makes domestic goods seem relatively expensive, which decreases exports. The net effect is an increase in the US trade deficit. This is good news for US companies that tend to import goods from other countries, but bad news for companies that rely on exporting goods to the rest of the world. Exporters can expect to face reduced profits as they decrease prices to entice foreigners into buying their goods. Smaller profits mean smaller returns to shareholders.

Europe has no shortage of internal disputes between member states, key among them being how to deal with Greece's massive debt that resulted from emergency loans made during the Eurozone debt crisis.

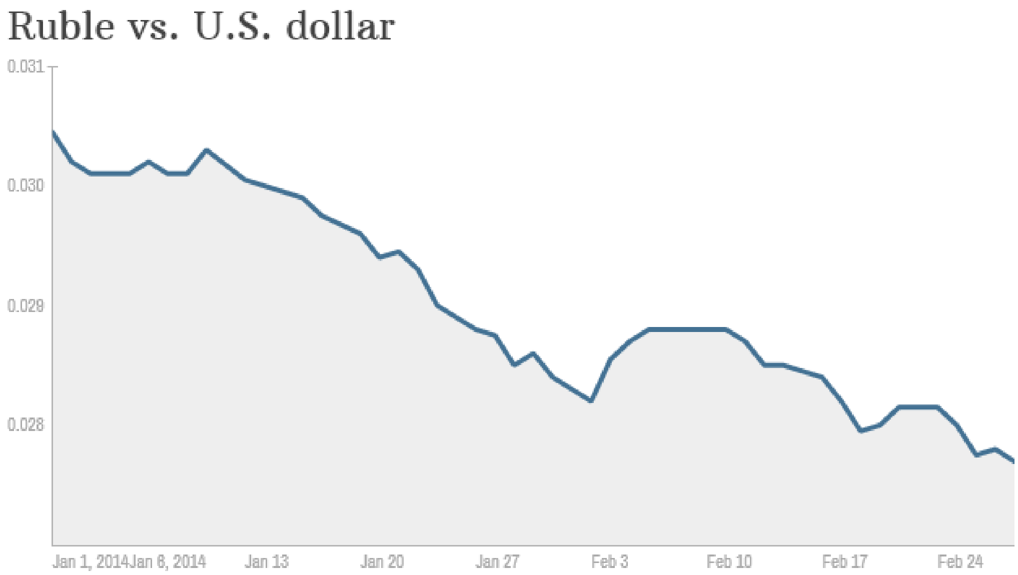
This debt issue is complicated, but began after the financial crisis of 2008. Although the international recession played a role in pushing Greece towards bankruptcy, most believe it was due to domestic factors within the country. Heavy spending by the government drove up borrowing in the years preceding the crisis. To make matters worse, the Greek Government has difficulty bringing in revenue due to rampant tax evasion blamed on corruption and lax enforcement. While Greeks were hiding from the taxman, public sector employees were receiving inflated benefits. A relatively weak economy also exposed Greece to more of the effects of the global recession than other parts of Europe. Rising deficits and falling growth caused markets to question whether Greece would be able to meet its debt obligations. These worries eventually drove crediting rating agencies to lower the value of Greek issued bonds to junk status in 2010. The subsequently high interest rates on newly issued debt made it nearly impossible for Greece to borrow to meet obligations. Realizing the dire consequences of letting Greece default on its debt, the ECB and the International Monetary fund stepped in and have since loaned Greece over 300 Billion Euros in bailout aid. The loans were contingent on Greece adopting various austerity measures that included fighting tax evasion, slashing benefits to public sector employees, and raising tax rates. As the largest economic power on the continent (and a big creditor to Greece), Germany played a key role in dictating the terms of austerity. The austerity reforms were fiercely unpopular in Greece, leading to protests and riots.

Many Greeks blame Germany for the hardships caused by the reforms, seeing it as the big, rich country bullying the small, poor one. The sentiment in Germany is expectedly different, thinking of Greeks as lazy free riders looking to leech off of German success. The truth is somewhere in between; poor domestic fiscal policy did cause the buildup of debt, but one might view parts of the austerity program as taking advantage of a poor country with no other alternatives. Regardless, the Greeks fiercely disliked how foreign nations were dictating their domestic policy. This growing sentiment led Syriza, a radical leftist party, to win the largest share of seats in Greek Parliament in an election early this year, which also gives the party executive power. Syriza campaigned primarily on the basis that it would fiercely negotiate with creditors on the terms of Greece's outstanding debt, which the country soon needs to begin repaying. As the terms stand now, Greece is unlikely to be able to meet obligations on time. Creditors, including Germany, will likely need to alter details of loan repayments, but such changes would be very unpopular domestically. Greece also needs to play its part in managing its ongoing debt and ensuring that corruption and tax evasion are combated. Syriza essentially promised that if elected, it wouldn't budge an inch in negotiations with Germany. This has infuriated Germans and made a compromise seem even less likely. Since then, the rhetoric on both sides of the debt talks has become more and more extreme, with meetings yielding little success. If no compromise is reached, Greece will likely default on its debt and be forced to abandon the Euro. Thankfully, Germans are still wary of this outcome, and recently voted to grant Greece a four-month extension on debt repayments. Syriza also seems dedicated to keeping Greece within the Eurozone, but campaign promises and the words of politicians seem to contradict this.

Further complicating the issue of altering the terms of Greek debt is that other European countries that borrowed from the IMF and the ECB are in similar, but not as severe situations as Greece. The idea is that, if no repayment agreement is made and Greece has to leave the Euro, similarly indebted nations like Portugal, Ireland, and Spain might also follow. On the other side, creditors are concerned that if concessions are made for Greek debt, the same will have to be made for other countries in Europe. The decision of Greek creditors has the potential to create a precedent for the entire European Union. Regardless, a four-month extension is no solution to the debt crisis. Hopefully it will give both sides time to reach a compromise.

The fallout between Syriza and creditors highlights a worrying issue for small countries in the Eurozone. Although Greeks elected Syriza to lead the country towards success, the reality is that the Greek economy is far more influenced by international factors than those that can be controlled by the Greek government. This challenges the value of Greece and other small nations being in the European Union in the first place. The debt crisis has the continent divided on the issue of the shared currency and EU membership in general. Many Europeans, both rich and poor, are questioning whether the EU can simultaneously pursue the goodwill of all member nations.

The EU is also in the midst of a political crisis. Last year, a Russian backed rebel army annexed part of the Ukraine amidst protests and riots. The war continues to rage on, with the Ukrainian economy at a standstill. NATO member states retaliated with sanctions against Russia, but it is unclear whether NATO will become more involved in the conflict. The Russian economy, which is heavily reliant on natural resources, is on the brink of recession, with the Rouble tumbling in value alongside sharp dips in oil prices. Reduced economic activity in Europe has contributed to this decline.

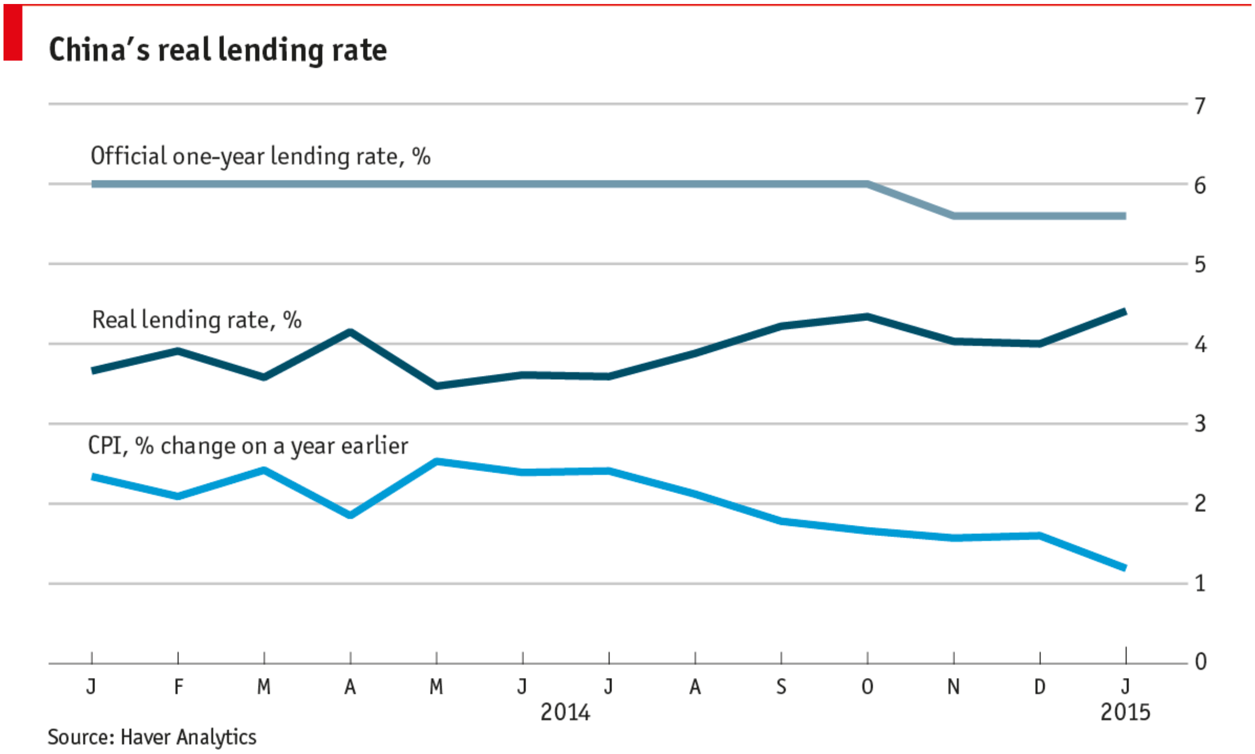



Overall, the European Economy appears to be stagnating under uncertainty. A recovery will be difficult amidst the various political issues plaguing the area.

## CHINA

**State of the economy and the Credit market**

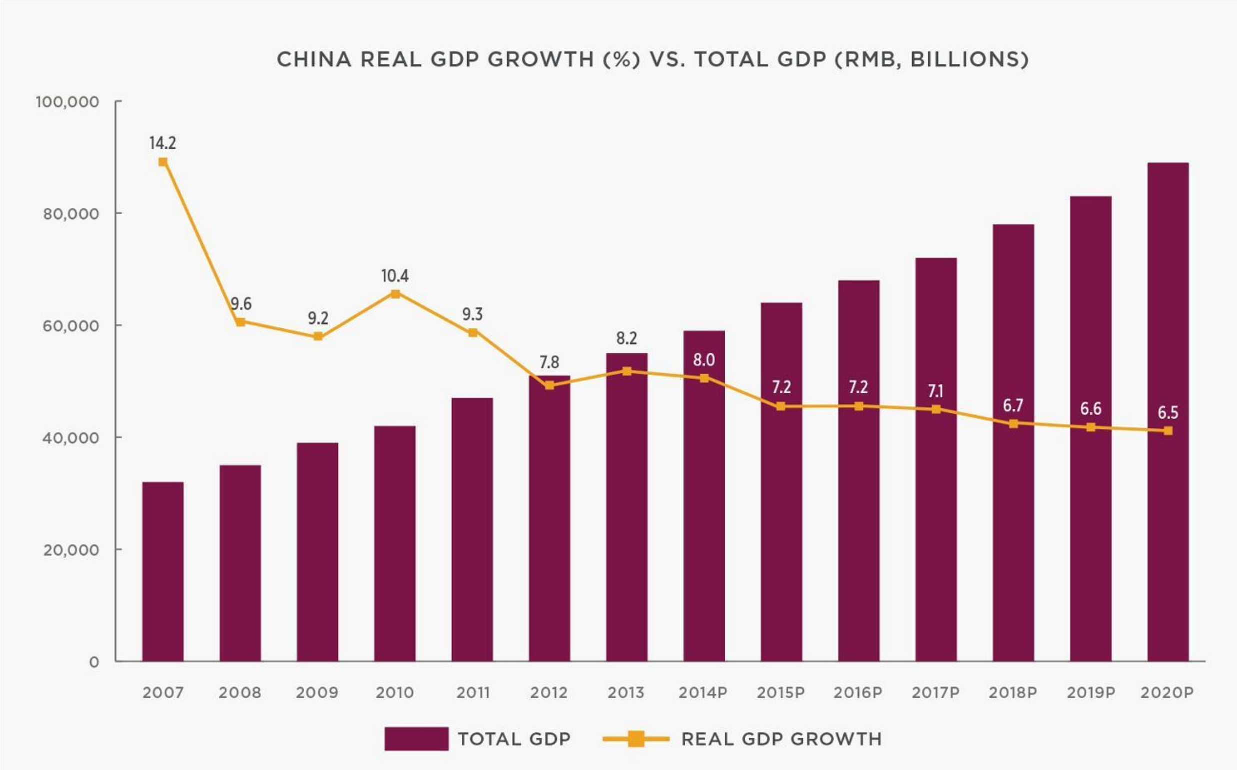
It is agreeable by many economists and data that China is going into the state of disinflation. Interest rate has been cut down for the third time in just three months, together with bank reserve. It is obvious that the government is trying to boost lending and spending, however their effort remains to be less than effective. Moreover, experts still believe that the government needs to cut down the interest rate further.




In China, government regulators directly impose lending controls on commercial bank. Also, most of China's financial institutions are state owned and governed and 98% of banking assets are state owned (Becky Chui, Reforming China's State Owned Enterprises and Banks), as such, political factor plays a critical, if not most important role, in shaping the credit market in China. Moreover, the new Chinese government led by President Xi has been taking major steps in anti-corruption effort and major economic transform, which would subsequently affect many different sectors within Chinese economy. Just this Monday, CEO of PetroChina was arrested and is prompted for investigation after the Party meeting which lasted five days.

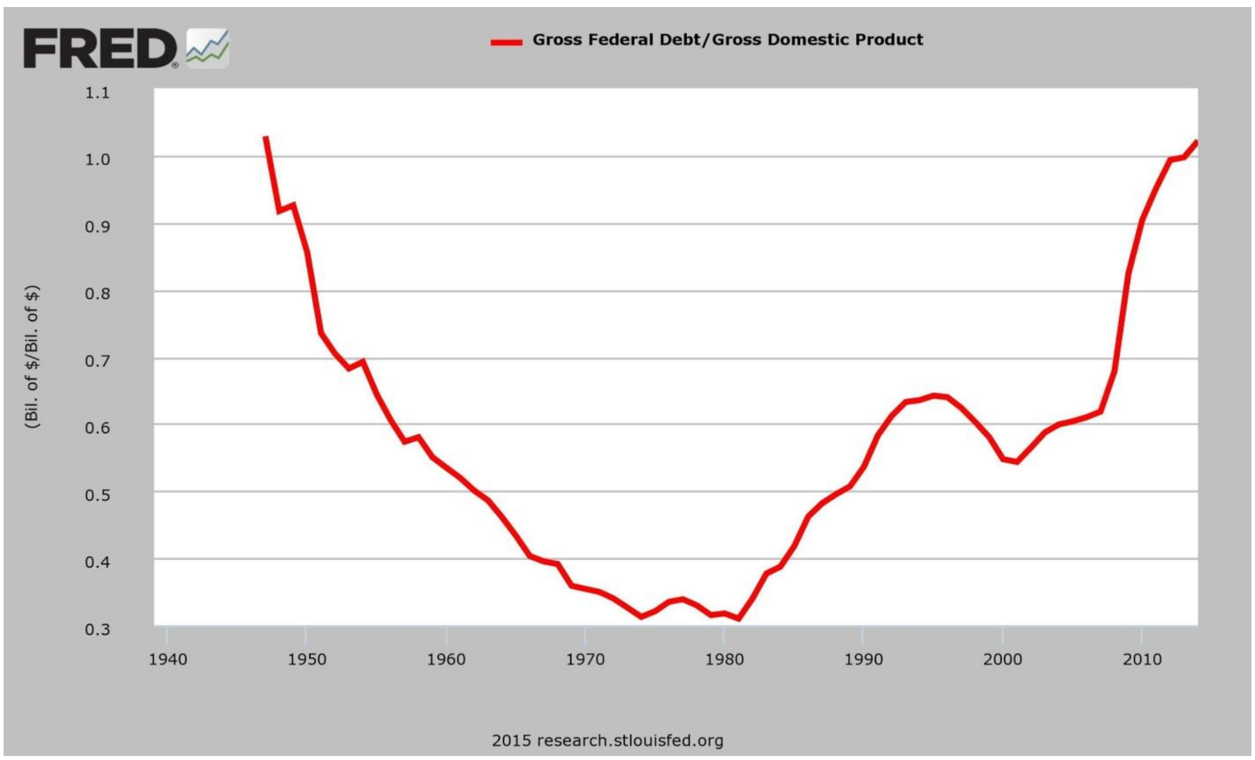
On a side note, China's real GDP growth rate has been declining from 7.7 in 2013 to 7.4 in 2014 and is projected to be in the range of 7.0-7.2% in 2015, and continuing to dip below 7% in following years.

EXHIBIT 1: China's GDP Expected to Continue Growth Trajectory

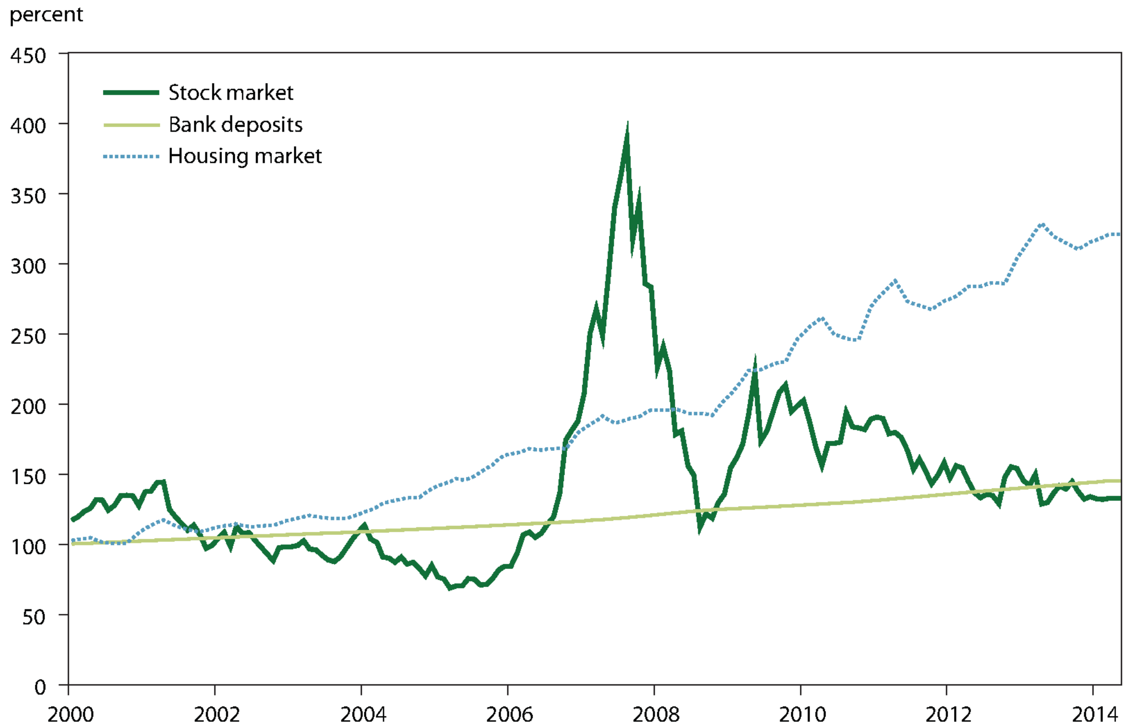



**Real estate bubble**

Roy Smith, 76, who was a Goldman Sachs Group Inc. partner and predicted Japan's 1990 bubble burst, said that: "The vulnerabilities in China today are very similar to the vulnerabilities in Japan." Moreover, China's total debt pile, including borrowing by households, banks, governments and companies, ballooned to 282 percent of national output in mid-2014 from 121 percent in 2000, according to an estimate by the McKinsey Global Institute. However, if we compare the government debt between China and the States, Chinese government is still doing a much better job when their debt to GDP is only around 22.4% as compare to more 100% of the States.


Recent official data shows house price declines in 55 out of 70 cities in June vs May and 35 out of 70 cities in May vs April. Sales volumes as measured by floor space are down 9.4% in the first seven months of 2014 vs the same period last year. This has shown that the real estate price has been approaching its peak when they become overpriced. However, the government itself has an enormous incentive to keep pumping the bubble up, since all land is technically owned by the state and land sales made up 60 per cent of local government's budgetary revenues last year, according to estimates from JPMorgan. When the local government can no longer profit from sale of land, this would greatly affect their budget to promote other economic goals.




*Source:* CEIC Data.

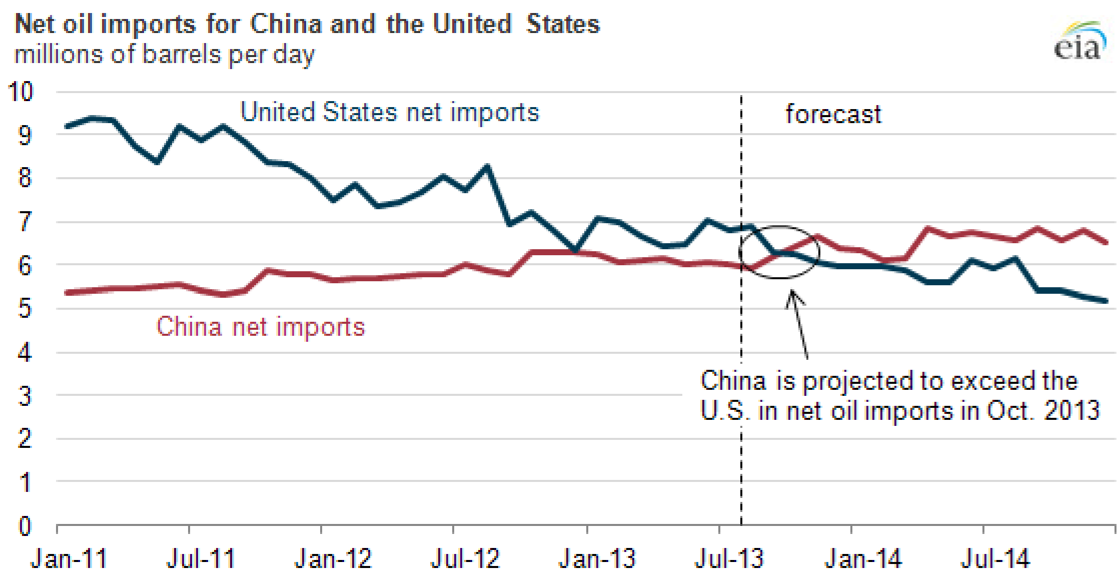
Such problems would be even more severe in Ghost cities in China, which are becoming more and more common. Cities that are under-populated financed their infrastructure development from sale of land to real estate developers might run into a lack of funding in the near future, especially when anti-corruption movements are becoming more and more viral in China.

A study by the Kansas City Fed also mentioned other demographic changes such as the aging population and decline of China's 24-30 years old population, the age group that need to purchase their first home, would further put pressure on the housing market in China.

All these factors would put China's real estate market into a vulnerable state, yet it might not be as bad as the situation in Japan due to different economic and cultural environment. However, the government needs to have immediate actions to prevent any further potential downswing of the sector.

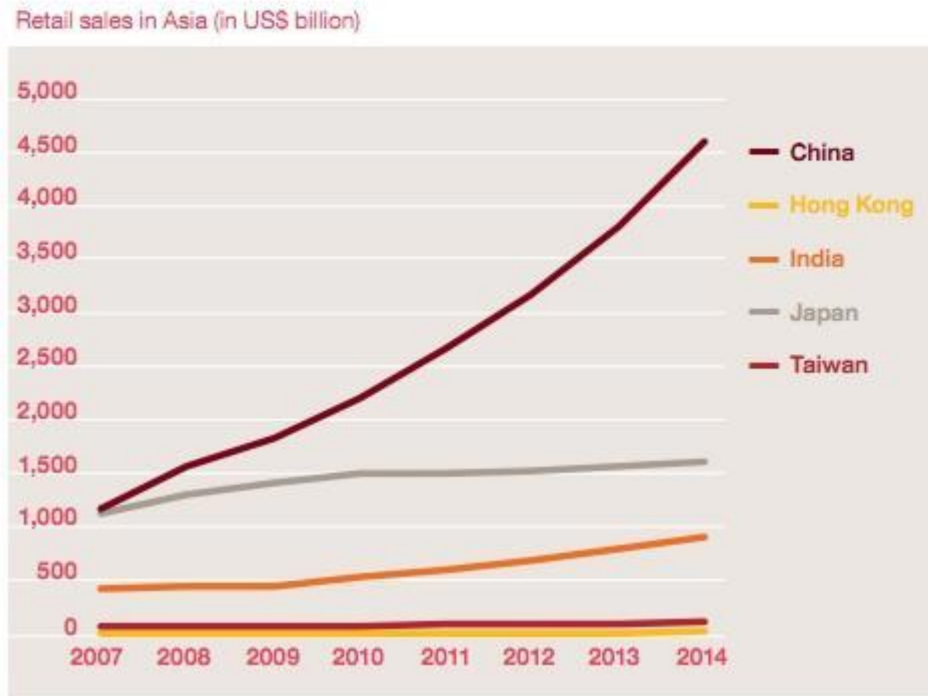
**China industrial and retail sector growth**

China is losing more and more comparative advantages as a manufacturing economy due to rising wages. In fact, the rate of growth across manufacturing and services was the weakest in eight months in January, according to an HSBC survey. However, the current low oil price has been beneficial to China as they are major importer of raw material and petroleum products used for production and consumption.




Soure: EIA

On a brighter note, the retail sector in China has been growing rapidly over the last few years, and is very likely to continue to grow in the following years. This will transform China from a manufacturing economy to a consuming economy that is much similar to the States.




Growth in China's purchasing power would provide a large market for US's exporting companies. In fact, according to China Customs statistics, Chinese imports worldwide increased by 1.0% during the first seven months of the year. Imports from the US, however, increased by 5.0%, far outperforming its global imports. This can affect many of our portfolios who can expand their business oversea such as Starbucks, Ely Lilly Inc., Western Digital, and Medtronic.

However, many other retail brand entrance into China would be facing a steep duties, together with a growing preference to purchase luxury goods abroad, where taxes are lower. Counterfeit would be another problem for China's retail market. Such issues would slow down business expansion into China's market. Yet at the end of the day, with the world's largest population and a growing purchasing power, China is still an attractive destination for retail companies.

**Investment Opportunities**

China can provide good investment opportunities, despite many grim outlooks by some economists. With around 7% annual GDP growth and a strong governor control on the economy, we would not expect a sudden crash down of their market, given the manufacturing sector nor the real estate sector, at least not in a near future. As a fund, BSIF should look into holding that can exploit the large and growing retail market in China.

# INDIA

India is a country to watch. With a population of over 1.2 billion people, it has one of the largest populations under one government in the world. It has a labor force of 487 million people, approximately 95% of whom are employed in unorganized (which is not to say disorganized) enterprises-- small, independent, private businesses with no corporate structure. This means there are approximately 10.2 million people in organized, private enterprise, of which BSIF holdings represent approximately 1%-- that is, something less than 0.0002% of all Indians. Can we reasonably say we have a presence in India?

The answer is absolutely yes. We have a diversified presence across the country, including infrastructure, defense, manufacturing, healthcare, technology, recreation, and consumer goods (see Appendix A for affected holdings). Our companies train and employ the high-skill, high-output people who drive economic growth. We are, at least to some degree, invested in every growing sector in the country-- and right now, growth is the name of the game, as India is expected to have one of the highest growth rates in the world next year.

That, of course, comes with some caveats: as of January 31st, the Central Bank of India has updated its base year and revised its method for calculating GDP. Transitioning from a factor cost method to a gross value added method has led to some startling revisions in the data: fiscal year 2013's 4.7% growth, not skimpy in any case, became a booming 6.9%. Because the fiscal year ends March 31st we will unfortunately not see FY2014's figures by publication time, but they are expected to be stronger still. At this rate, by these measures, India's growth rate may soon overtake China's.

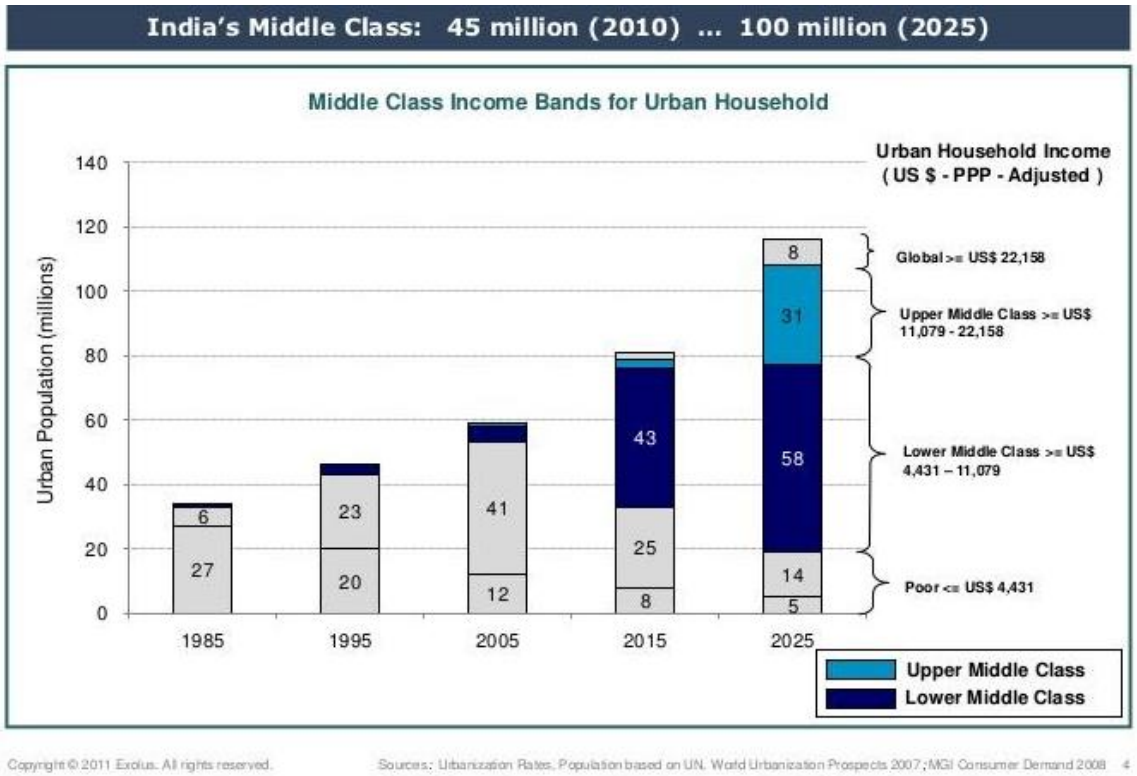
Politically, there is good reason to be optimistic about India. The recently elected Prime Minister Narendra Modi has shown himself to be very pro-growth. His policies are generally oriented towards reducing corruption, eliminating red tape, and encouraging foreign direct investment, making India an increasingly attractive place to do business. Modi's government does face headwinds, however: opposition parties have criticized his human development record and also claim that per the new GDP calculations, the previous government was not the failure he had criticized them for being during his campaign.

Finance minister Arun Jaitley and governor of the Central Bank of India Raghuram Rajan are also making adjustments to the country's banking system to allow capital to flow more freely. Private and publicly run banks currently exist side-by-side. Hampered by political interference and union opposition, reforms to the state-run banks have been discussed but failed to materialize in the past. Look for changes to the public banks' structure, governance, and asset quality to be forthcoming along with consolidations to improve efficiency.

The exact extent of the global recovery in India is difficult to pin down. Part of the problem comes from a paucity of current data. For one thing, the new GDP calculations are still being resolved with other economic indicators, and it will take time to draw the right inferences from the new relationships in the data. For another, long lag times and notoriously slippery definitions plague all economic research, and India is by no means immune. The World Bank pegs India's unemployment rate at 3.9%, but the latest data are from 2013. Some estimates range as high as 9%, but accuracy is muddled by the culture's fluid, entrepreneurial attitude towards work in general. Such issues will continue to vex analysts until India's data gathering, processing, and dissemination infrastructure matures

Investors have many good reasons to be in India, but as a fund the BSIF must be cautiously optimistic. The government is committed to making India business-friendly, but Modi's reforms must be carried on by his successor and supported by the rest of Parliament. A maturing financial sector will help capital to flow more efficiently, but it will take only one mis-behaving bank to ruin the industry's reputation. The country's demographic shifts from rural to urban and a burgeoning working-age population will make labor plentiful, but may also engender some political unrest.

Furthermore, we must also keep in mind that whatever India is, it isn't China 2.0. As a democracy, the political will to enact growth-positive reforms is far more diluted, retarding the pace of economic evolution. Expect India to bloom on a time frame of many years, not quarters. They are a net importer whose GDP is driven by 1.2 billion consumers, many of them in service sectors. No, India is not China, but this is some of the best news the BSIF can get.




In order to invest in India, the most important question is not "do they *produce in* India," but "do they *sell to* India." As household incomes begin to raise, the standard, familiar quality of established US and European brands will increasingly catch on. High-profile brands with a strong presence include Starbucks, P&G, Harley Davidson, and many others which the Fund does not yet hold such as Nestle and Whirlpool. Firms like Eli Lilly have a lower profile, but market their products no less effectively. While most of the money in India's new growth will be made in securities that fall outside our investment guidelines, student analysts should take a company's strong or strengthening Indian presence as a positive. Please refer to appendix for more information about India.

## CONCLUSION

The United States are doing well, but there is still slack in the labor market. We expect an interest rate hike this year. Europe is political uncertainty, which is making the recovery more difficult. However, in the long-run, quantitative easing and a weak Euro will help the Euro zone to recover. China is facing deflationary pressure but is still performing well overall. Its retail sector might provide opportunities for current and future holdings. At the same time, we should also start looking at India. Overall, we expect a global rebalancing as a strong US Dollar and devalued currencies abroad will cause capital to flow out of the country with increasing imports and decreasing exports.

## APPENDIX: AFFECTED BSIF HOLDINGS IN INDIA

- CAT-- Caterpillar, Inc.
    - Manufacturing
    - R&D
    - Dealers & maintenance facilities
- DOV-- Dover Corporation
    - Manufacturing
        - Chennai (industrial automation & fluid machinery)
        - Noida (Markem-Imaje printers)
    - India Innovation Center (Engineering services & design)
- BP-- British Petroleum
    - Stakeholder in partially-privatized oil/gas production sector
    - Lubricant, petrochemical production
    - Outsource procurement, IT, and finance to India
- SBUX-- Starbucks
    - 63 locations
- ENS-- EnerSys
    - Via Energy Leader subsidiary
    - Four main markets
        - Specialty power
        - Motive power (rail &c)
        - Aerospace/Defense
        - Reserve power
- MDT-- Medtronic
    - Whatever they do, they do it in India, too.
        - Cardiovascular health, diabetes
        - “Restorative therapies”
        - Surgical technology
- PG-- Procter & Gamble
    - Five owned manufacturing plants
    - Nine contracted manufacturers
    - Major consumer goods player
- NOC-- Northrop-Grumman

    - Military and civil comms, radar, and navigation
    - “strategic industrial partnerships”
- UPS-- United Parcel Service
    - Again, they do it in India, too
- WDC-- Western Digital
    - Provide hard drives to expanding Indian tech market
- BUD-- Anheuser-Busch InBev
    - Small market share (<=10%)
    - Recent (2007) entrant to Indian market
    - Sell Budweiser in direct competition to local brews and SABMiller (rather than buy-consolidate strategy)
- HOG-- Harley Davidson
    - 15 dealerships, 1 assembly plant, 1 manufacturing plant (only one outside US)
    - Export Street 750 to Europe and Asia markets
- LLY-- Ely Lilly Inc.
    - Distribute major brands to Indian market (Humalog, Huminsulin, Trajentra)