Investment Environment Committee Report-
Fall 2015

BSIF
STUDENT INVESTORS

David Newell, David Shoko, Tim Hudson, Julian Fung and Daniel Duarte

Table of Contents

Statement of Purpose 3

Federal Reserve 3

Macroeconomic Regions Trends and Outlook 4

- **Domestic** 4
- **Europe** 6
- **China** 9
- **Emerging Markets** 14

Select Sector Trends and Outlook 15

- **Basic Materials** 15
- **Consumer Defensive** 17
- **Healthcare** 17
- **Utilities** 18

Conclusion 19

Statement of Purpose

The Investment Committee of the Bulldog Student Investment Fund produces a biannual top down examination of the domestic and global economy and sectors of particular interest to the members of the Fund. The objective of the report is to provide information on applicable and current economic trends and events. This information helps the Sector Pitch Teams and the Students Analysts as a whole to evaluate the individual stocks that are pitched.

Federal Reserve

With the strength of the United States economy, investors expected a rate hike in September as unemployment was at 5.1%; GDP growth was substantially strong. However, the Federal Reserve did not raise rates in September due to the volatility of the Chinese stock exchange. From its peak in June, the Shenzhen has fallen 35% in value. The global economic slowdown led by China and Europe made the Fed concerned that raising rates would not be a good move. The strong US Dollar also made the Federal Reserve hold off because a rate hike would make the US Dollar even stronger, which would be damaging for global economic growth. From this hold off from the Fed, we see a "confused" Fed that now has a third mandate, the global economy. However, from the speech given by Yellen we anticipate a Federal Reserve rate hike in December when she said:

> *"Most FOMC participants, including myself, currently anticipate that achieving these conditions will likely entail an initial increase in the federal funds rate later this year, followed by a gradual pace of tightening thereafter"*
>
> *(Bloomberg)*

Some analysts were anticipating an October rate hike placing a 50-50 chance on the hike, but we think that it is highly unlikely that there will be a Federal Reserve rate hike. This is because global growth concerns will not go away and the U.S. employment report was poor as it was below expectations. The Investment Environment Committee feels that with the sluggish U.S. economy we think the probability for a December rate hike is decreasing, but we feel like it is on the table for Janet Yellen.

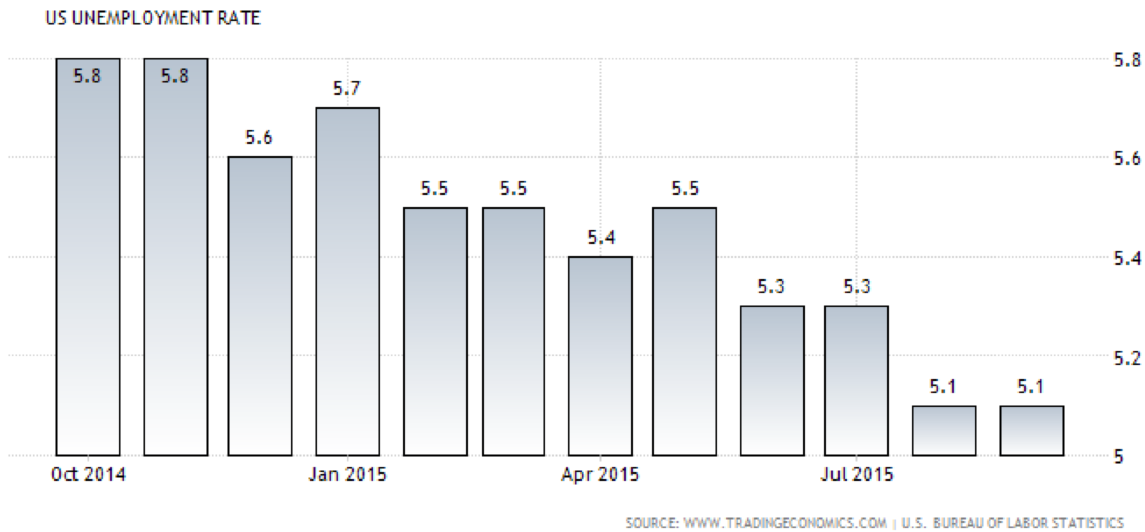
Macroeconomic Regions Trends and Outlook

Domestic

Economic performance on the domestic front, from a high-level perspective, is in relatively good shape. While the oil industry in the U.S. is still a point of significant concern for analysts, the housing market, capital investments, and even the dollar seem to fit well into the bull category.

Global oil production has stayed consistently high over the past several months. Iraq has actually begun to accelerate its oil production. Speculation has continued, saying that the U.S. may cut back on production in the next few months, but no real evidence seems to point to that conclusion. Economic problems abroad, namely in China and Europe, seem to indicate that global demand for oil will begin to decline. These factors will continue to drive down prices, and only hurt domestic oil companies. Capital investments for these markets remain at all but a standstill, which is negatively affecting many industries tangentially related to oil. While uncertainty is probably the biggest distinguishing factor of this market today, many expect the unreasonably low oil prices will continue through at least 2017.

Unemployment has steadily decreased from 5.8% in October 2014 to 5.0% in October 2015. The November unemployment figures came in particularly strong, falling to 5% in October as the number of new job creations greatly exceed expectations. According to the Federal Reserve Bank of St. Louis, the natural rate of unemployment is approximately 5%. Intuitively, the Fed expects the domestic unemployment rate's equilibrium to be 5% in the long-term future. The labor force participation rate also hit a record-breaking low in September of 62.4%, the lowest since 1977. One might expect that unemployment would be decreasing at an accelerated rate with such a dramatic shrinkage in the labor force, but there are some positives in the domestic labor market today. Real income growth per family has risen to 4.8% in 2014, which is by far the most substantial growth since the Great Recession. Real income levels for middle and lower class families are still much lower than pre-2007 data; however, these leaps forward have proved encouraging for economists. As is likely surprising to few, income inequality is continuing to increase. Domestic employment seems to be on the right recovery tract, and while its trajectory has seen its fair share of pitfalls, this U.S. market is still a world leader.



Recent information has indicated that the Federal Reserve may postpone rate hikes until 2016 [see the Federal Reserve]. This news has recently minimally weakened the U.S. Dollar in the short term. However, expectations are that it will continue to be a strong and leading currency for the near future.

Housing remains one of the strongest aspects of U.S. economy today, with analysts claiming it is at an 8-year high. Groundbreaking is steadily increasing, so supply is growing to meet new demand. That said inventories are still too low to meet consumer demand in most markets across the U.S. Every indication points to a continued increase in demand over the next twelve months. Banks are also increasingly more willing to assume higher risks as mortgage lending continues to increase. This trend is expected to substantially accelerate when interest rates go up.

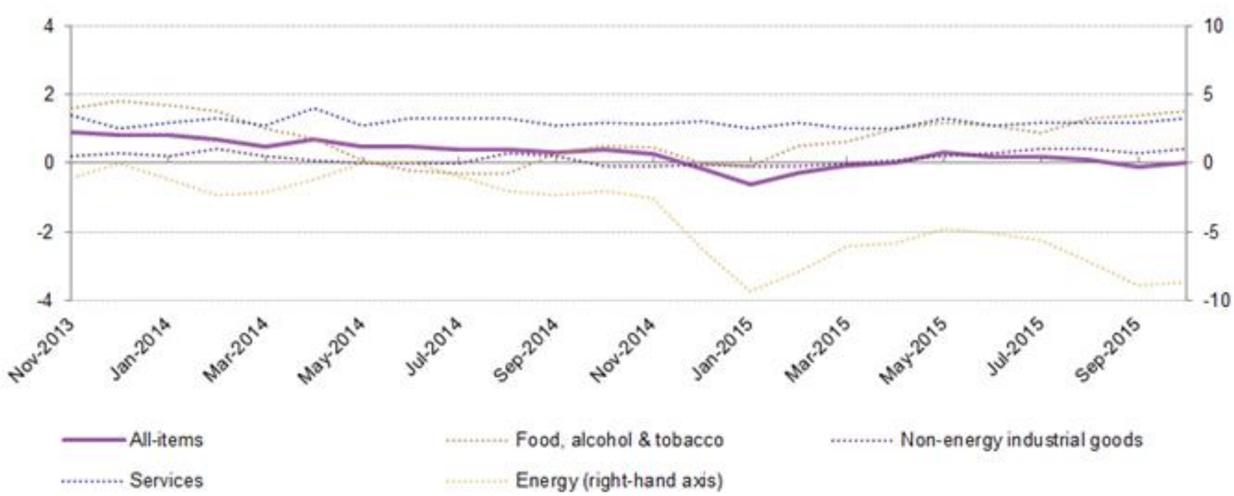
Core capital goods orders increased by 2.2% in July, the most in over a year. This increase in capital investment has been consistent across most sectors, with the clear exception of the energy industry. As previously stated, capital investment has been virtually non-existent in oil-related sectors due to continued low prices. This problem has permeated into the majority of companies in the energy industry, and will likely have significant long-term repercussions. Outside of this industry, many domestic corporations are investing more in the future than before the Great Recession.

From an equity investment perspective, companies with a large domestic presence are still some of the strongest contenders in stock markets. Construction and other housing-related sectors likely have a strong year ahead. The energy sector could continue to face a bear market conditions in the near term. U.S. based companies are, in general, making substantial capital investments in their futures. This will continue to open many possibilities for the Fund's long-term strategies.

Europe

After gaining momentum in the first quarter and showing signs of continuing growth after benefiting from low energy prices, a weaker euro, and the recent quantitative easing program undertaken by the European Central Bank, Europe's economy has lost momentum in the second quarter. Additionally, expectations of falling into deflation are now a concern as recent data released by the ECB showed a decline in the inflation rate from 0.1% in August to -0.1% in September (See graph below).

However, expected inflation in October is estimated to have a slight recovery and stabilize at the 0% level. The low energy prices are the main reasons behind the low estimates of inflation. Deflation could potentially turn into a big problem as private consumption, the main driver of GDP growth in the first quarter, could decline to extreme levels as consumers postpone spending and investment decisions. On the positive side, analysts predict a continued modest economic expansion, which will allow correcting for the effects of the sharp decline in energy prices and picking up inflation. Core inflation rate (excluding energy and unprocessed food) was 0.9% in September. Although this figure is higher and shows the impact of low oil prices, it remains far below the 2 percent inflation rate objective.



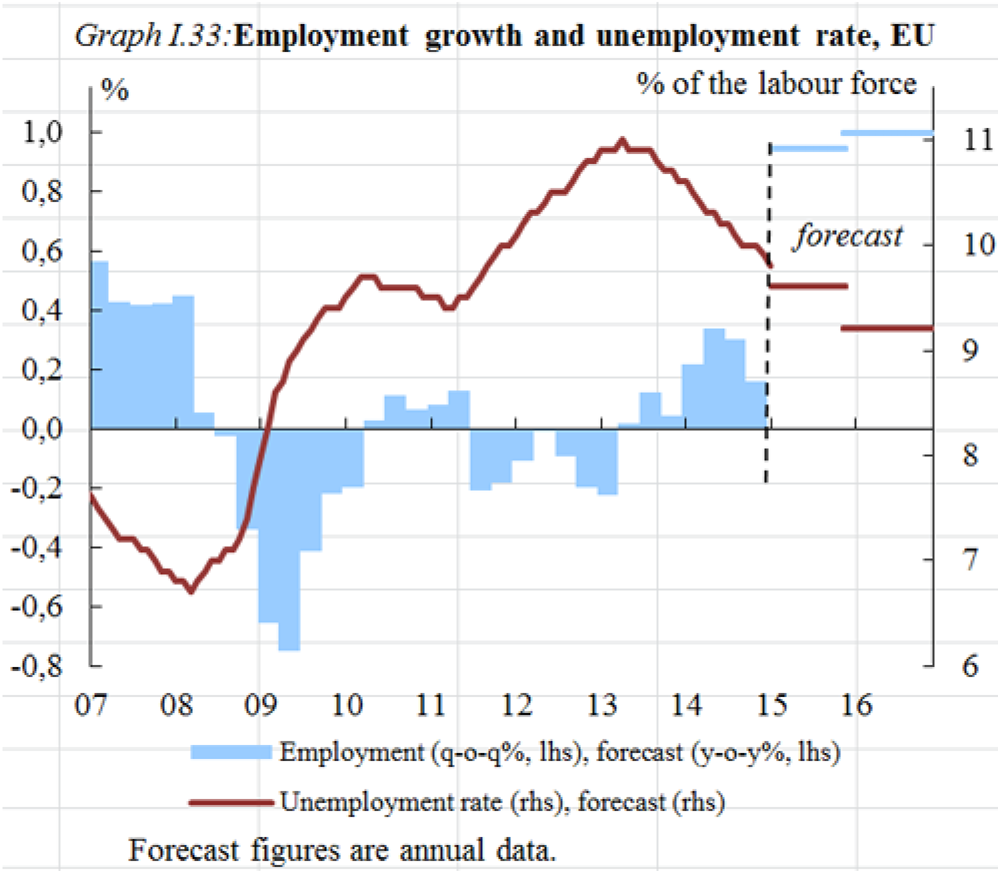
(Eurostat)

The European Central Bank is planning on maintaining its assets purchase program (APP) along with the acquisition of covered bonds and asset-backed securities until at least inflation expectations take an upward trend. The program started with a monthly injection of 60 billion euros, however, in the past month of September there were signs of rising expectations of a possible increase of the assets purchase program given the negative inflation rate recorded in September (-0.1%). As a result of the quantitative easing program launched by the European Central Bank, interest rate have fallen close to the zero bound supporting bank lending, which have substantially become more liquid. In addition, easing credit conditions have contributed to economic growth and a better outlook of the financial market with higher asset prices. Further economic growth will depend on how the banks continue to use their excess liquidity in the market. If it is used correctly, as it has been registered, improvements in the economy are expected and the assets purchase program may end on time (September 2016).

The divergence between monetary policy decisions between the European Central Bank and the Federal Reserve will continue contributing to the weakening of the Euro as expectations of a Federal Reserve interest rate hike in December increases, and the European economy starts feeling the effects of the quantitative easing program. A weaker Euro is positive for the European economy mainly due to two factors: depreciation will trigger higher import prices, and consequently increasing the inflation rate. The second factor is that European exports continue to be more competitive in the global economy. However, the rise in imports have been offsetting the benefits from increasing exports, thus exports will contribute only a small portion to economic growth.

Dollar vs. the Euro (European Central Bank)

The major obstacle for the European Union economy continues to be its tight labor market, especially in countries such as Spain, Italy and Greece where the unemployment rate reaches up to 22% among the young adult population. Economic activity supported by the Quantitative Easing program launched by the ECB will keep benefiting the labor market as consumer demand strengthens and growth picks up. Unemployment has been declining over the last two years (see graph below), and it is expected to decline even more in 2016. The figures recorded showed a significant improvement from last year's unemployment rate, which was 10.1% in September 2014, compared to 9.5% in September of this year. Although the current trend of the unemployment rate is following is a signal of improvement, unemployment remains very high and major structural reforms in highly indebted countries are still required. Germany, the strongest economy in the Eurozone, registered the lowest unemployment rate (4.5%), while the highest, not surprisingly, were registered in Greece (25%) and Spain (21.6%).

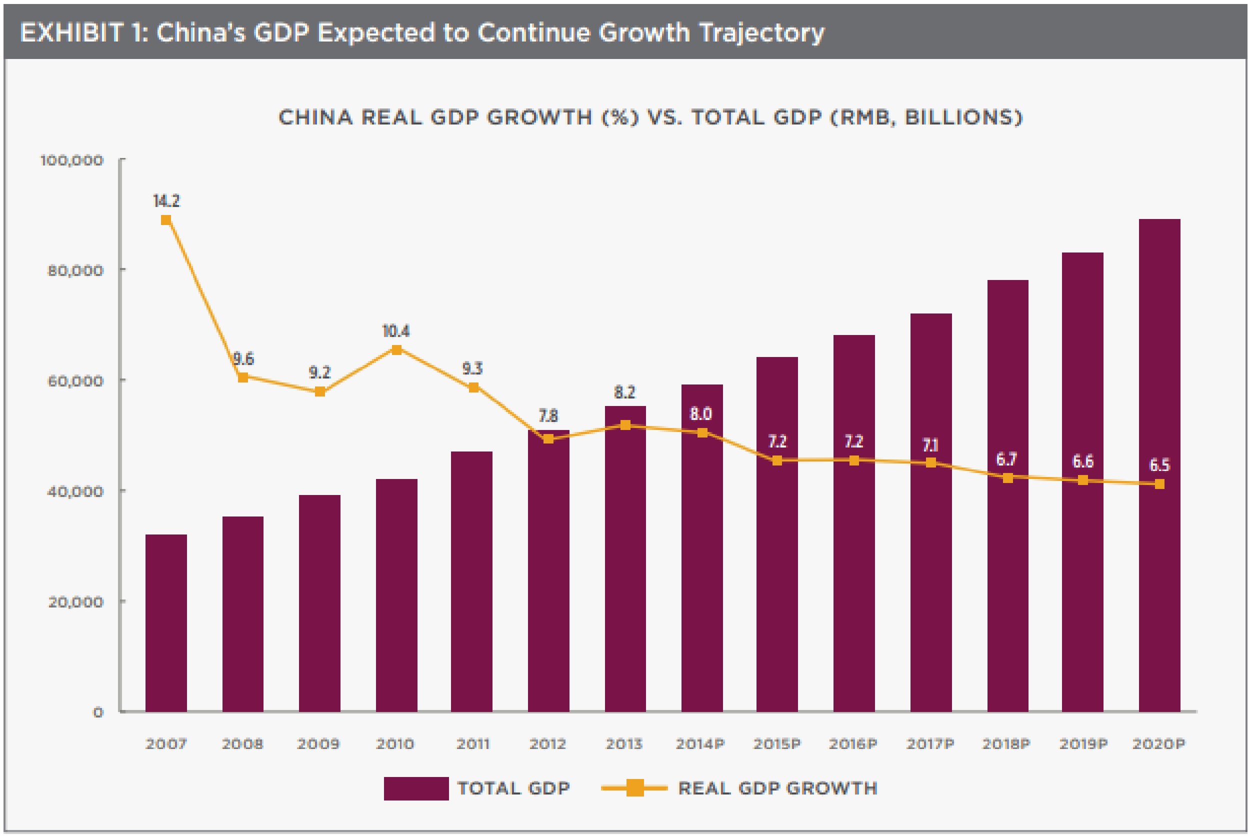


(European Commission)

China

State of the economy

China has been a frequent topic of discussion in the news globally in the past few months, after going through an extreme cycle of ups and downs this year. The stock market skyrocketed in the first two quarters and then plunged deeply in the third quarter and has since recovered considerably. Interest rates have been cut for the fifth time since November 2014, and the Chinese government devalued the Yuan by 2%; all in its attempt to stimulate the economy and recover from pandemonium. China's debt has been growing faster than its economy. According to the McKinsey Global Institute, its total debt pile, including borrowing by the government, banks, corporations and households, had expanded to a whopping 282% of its GDP. Although 282% is at the high end for developing nations, it is well below total debt levels in some more mature economies, such as the euro-area crisis countries, from near 300% for Greece to more than 400% for Ireland.

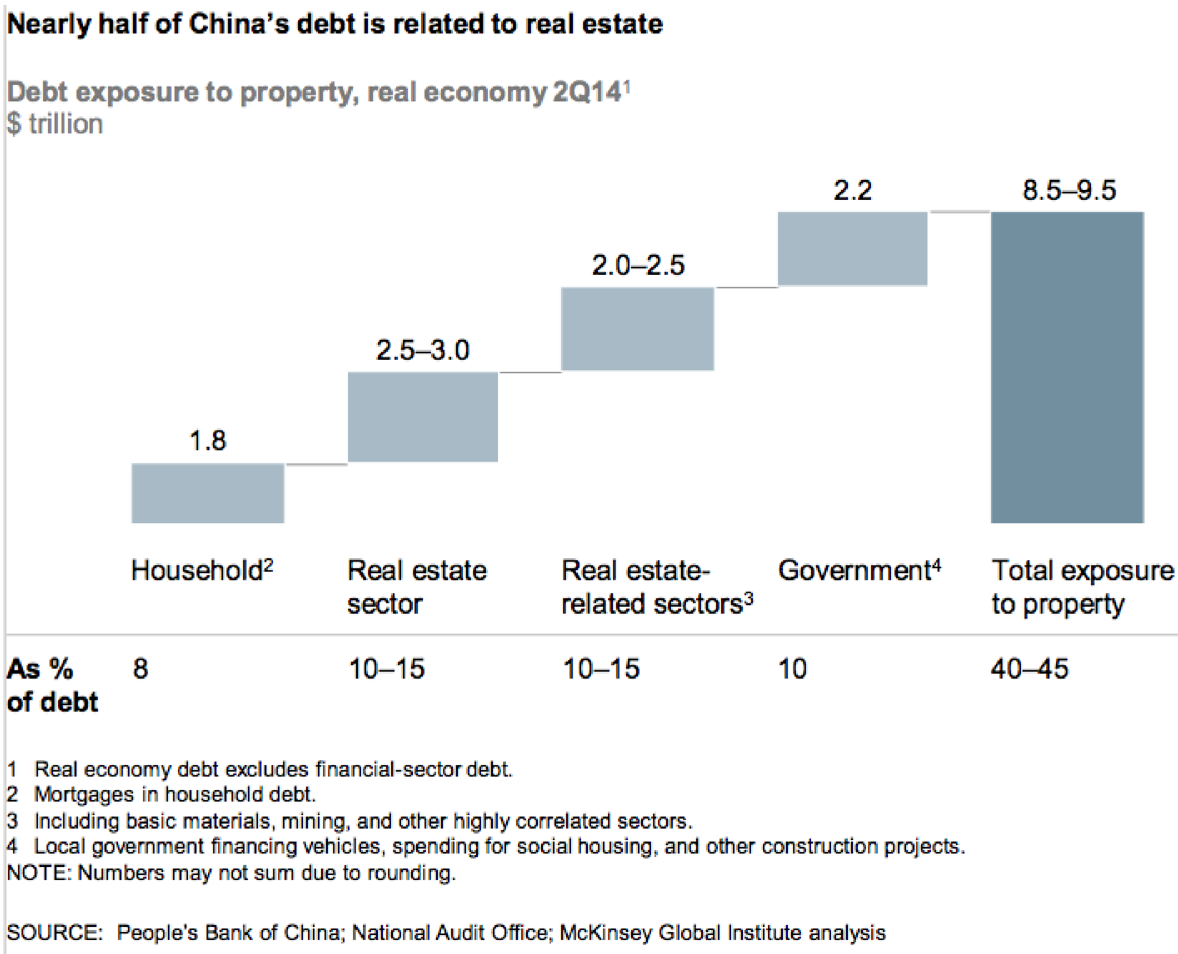


(Kurt Salmon)

On the other hand, China's real GDP growth has been declining from 7.4% in 2014 to 7% in 2015 and is projected to decline further below 7% in the following years. Furthermore, China's GDP growth has been declining faster than trajectory forecasts as seen in the graph below.

Real Estate bubble

Of China's 282% debt to GDP ratio, the government debt to GDP is 41% in 2014, up from the 39% in 2013, reaching an all-time high. On top of that, China's economy accounts for more than a third of total debt growth globally, adding $20.8 trillion in new debt since 2007. Furthermore, the largest driver of this growth is borrowing in real estate, non-financial corporations and property developers. China now has one of the highest corporate debt levels in the world, at 125% of GDP.

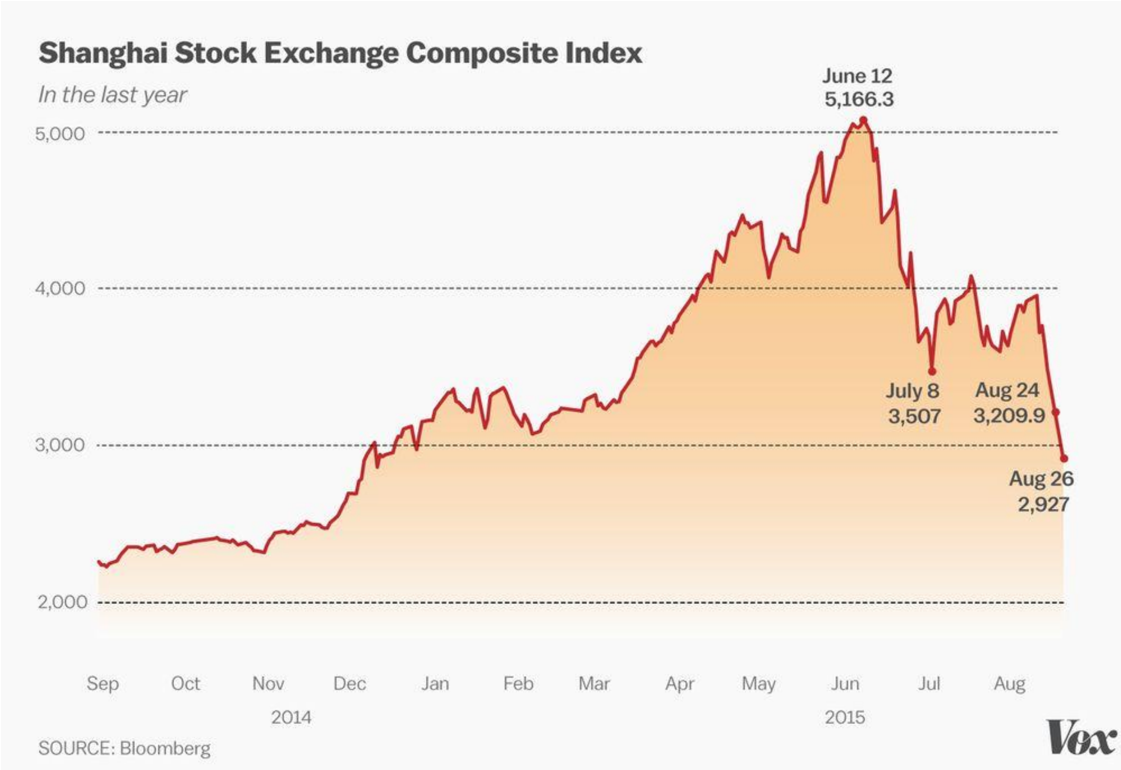


With half of China's debt related to real estate, fears of a property crash and corporate defaults are all major concerns. The combination of an overextended property sector and unsustainable finances of local governments could result in a series of loan defaults in China. This could damage banking systems and potentially create a wave of losses for investors and companies that have stored money in shadow banking vehicles. All these factors will potentially damage economic growth; however, the McKinsey Institute said that the Chinese government "could probably bail out the financial sector even if default rates were to reach crisis levels."

Stock market crash

The recent Chinese stock market crash in the third quarter of 2015 caused the Shanghai composite index and the Shenzhen index to dip over 30%, with high fluctuations after. Chinese investors are going back and forth with stocks and real estate, as they try to find stable safe havens among different investment vehicles. After the stock market crash, the average

Chinese have few investment options, and some of the money from stocks are being plowed right back into property.



However, the damage of the stock market crash to its economy has been surprisingly contained, considering the size and hype of the crash. At one point, the Shanghai composite dropped 8 percent in one day, but Shanghai itself remained unfazed as stores, public services, and institutions were still up and running and everyone was going to work.

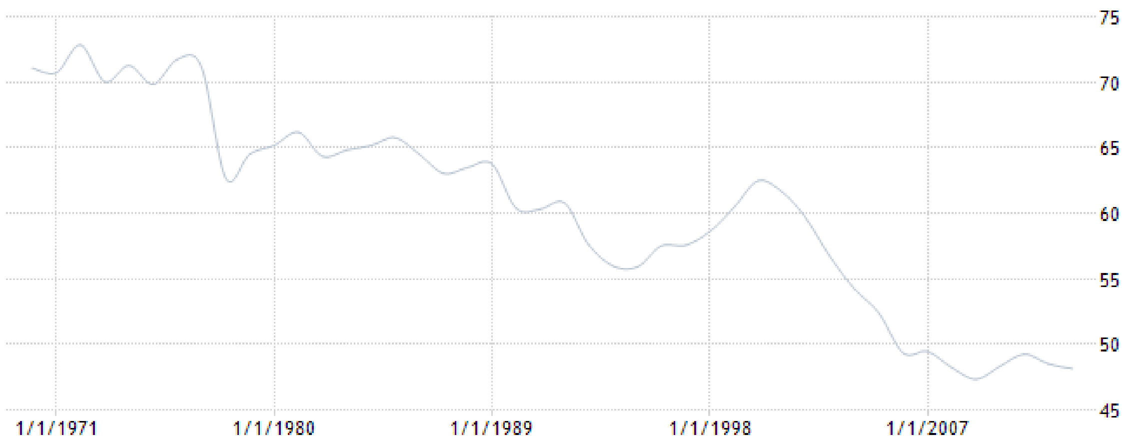
In examining the bigger picture, 50 to 90 million stock traders may seem like a large number, but it is in fact rather small when contextualized against the country's 1.37 billion people. According to surveys, only 6% - 8% of China's households invest in stocks, as opposed to 55% in the United States. Moreover, foreign investments only account for about 1 to 1.5% of the Chinese stock market.

In short, the Chinese stock market is not its economy. There may be some negative effects, but it is like to have minimal effects on the economy in the short run and most likely for the long run as well. However, only time will tell.

Transition to a consumption-driven economy

China is in the midst of a colossal shift in its economy that is rattling global markets. China's economy is undoubtedly slowing down. This slowdown is part of a bumpy transition away from huge exports and massive infrastructure spending alongside trillions of dollars of debt as it is proving unsustainable. Not only are exporting demands decreasing tremendously, debt has swelled to more than twice the size of the economy, and China is unable to grow at double digit GDP rates any longer. Instead, China is pushing services, consumer spending, and private entrepreneurship as new sources of growth that rely less on debt and more on the stock market for funding.

China's Final Consumption Expenditure (Percent of GDP)



However, reorienting China is proving difficult and challenging to Chinese leaders. China's total consumption share of GDP (sum of private and general government consumption) was reported to be around 48%, with private consumption at around 35%. This figure has been steadily decreasing since the past decade. The Chinese government is having difficulties to change the Chinese's saving and spending habits, as they are known to be really frugal and live very simple lifestyles.

On the other hand, China's consumer spending increased over 9% in raw numbers, and has been steadily increasing since 2006. This however, is not robust enough to replace the heavy industry and investment in infrastructure and property that powered China's nearly 10% annual growth for the past few decades.

All these factors puts China in a difficult position as they struggle to find a new status quo. Industries such as construction and steel will be affected negatively due to this transition in China's economy. Equities that can capture the increasing consumption in China is an area that the Fund should examine. Stocks tied directly or indirectly to China will need to be kept under high scrutiny due to the changing demand in imports and exports.

Emerging Markets

The Emerging Markets are facing a couple of major headwinds: the strong U.S. dollar and the weakening Chinese economy.

The U.S. dollar has strengthened over the past year, which has led to a depreciation of emerging market currencies. This has led to exports from the emerging markets to become cheaper in the U.S. and other nations. However, the stronger U.S. dollar makes it harder for companies in the emerging markets to service their dollar denominated debt.

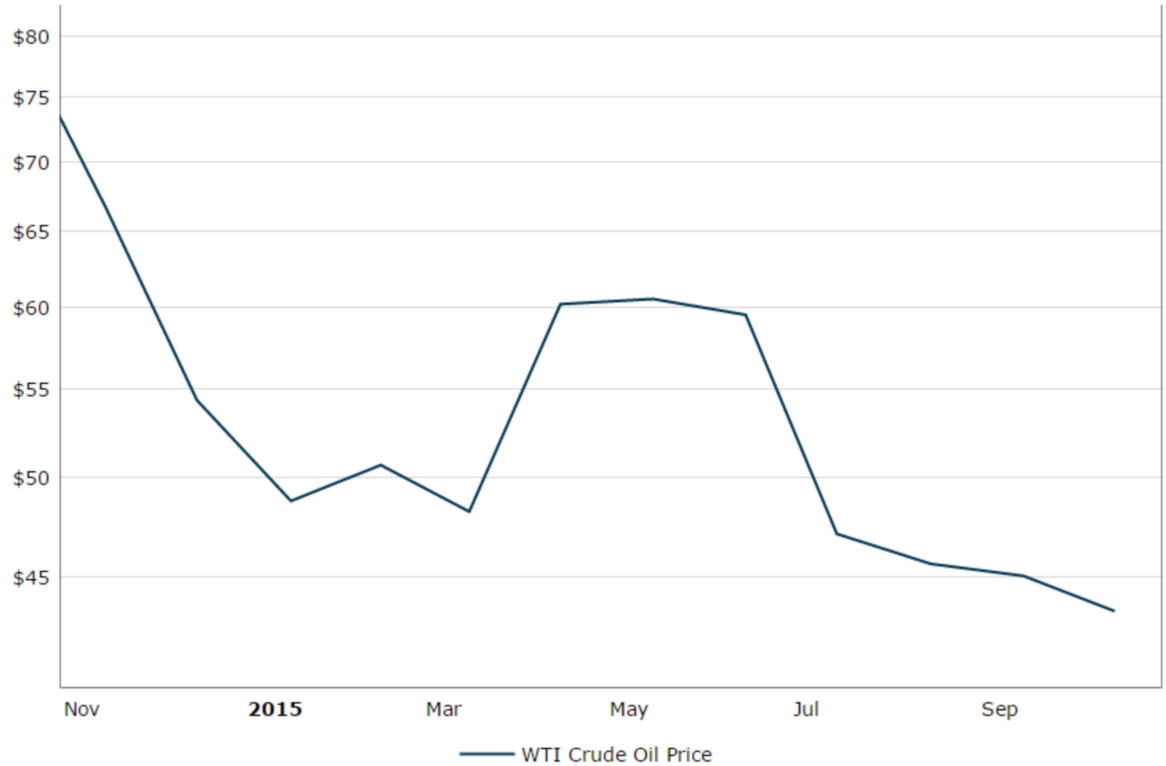
On the other side, the slowdown in China has posed some difficulties for emerging market economies that are heavily dependent on commodities. In the second half of 2014 oil prices fell and have not yet recovered. In the past months, a wide variety of other commodities has endured a decrease in prices in part due to the weakening global economy. The drop in commodity prices has reduced government revenue in a number of economies including Brazil, Nigeria and Russia. In addition, this led to plans for construction of new production facilities for commodities to be canceled. The lower commodity prices will provide a tailwind for the emerging market economies that are net importers of commodities such as India. In addition, the lower oil prices is reducing the burden of energy subsidies that emerging markets economies including India, Indonesia and Nigeria and allowing the governments to permanently reduce the subsidies. In the intermediate to longer term, many of these headwinds will subside.

One of the most promising emerging markets is Vietnam; it is well positioned to take advantage of the continued increase in wages in China as more manufacturing is shifted to lower cost locations. Another major potential advantage with Vietnam is the Trans-Pacific Partnership (TPP), when the TPP is ratified by the 12 governments in the trade agreement, the exports from Vietnam will become significantly more attractive due to the reduce of protectionistic tariffs.

Select Sector Trends and Outlook

Basic Materials

The Basic Materials sectors given the current economic conditions has been the most sensitive to huge market sell offs. As this sector is commodity driven, the weak Chinese and global demand has caused commodity prices to drop significantly. These commodities include copper, coal, aluminum and gold, which has led to companies related to these commodities to be sold off across the sector. Stocks in this sector have capitulated and are in bear territory and the fear index in this sector is very high. However, with most stocks in bear market territory the Investment Environment Committee see some value prospects in this space and good stock picking within this sector is required. Companies like Alcoa, with good value prospects look attractive as the company is reinventing itself to face the current economic environment. The charts below show the price drops of some of the commodities:



(Macro Trends)

Copper Price (Bloomberg

Consumer Defensive

The consumer defensive sector consists of items that are characterized as being household necessities. Thus, consumers, regardless of the market outlook, will continue spending in goods that fall under this category. Two key aspects in the current market will continue benefiting the sector: lower energy prices and unstable consumer confidence. The first is said to have a positive effect on the consumer defensive sector since low energy prices are translating into lower production costs for companies in these industries, hence bolstering their profit margins. In addition, lower gas prices mean that consumers will see an increase in their disposable incomes, thus allowing them to increase consumption in consumer defensive goods like beverages.

Besides, of the defensive character, this sector possesses a very valuable characteristic when it comes to dealing with volatile markets such as those that are expected in the few months to come. Given that consumers value stability, there will be a move towards the defensive sector given the proximity of a Federal Reserve rate hike. Therefore, a well-selected company with a strong balance sheet with the potential of growing faster than its competitors will allow the fund to cushion any possible falls in the market.

With the positive outlook of the U.S. economy and the strong dollar, the currency head winds of a firm with large international exposure should be taken into account. However, closer attention to the sector should be given as the recent attempts by central banks to pick up growth may drive investors towards sectors that are more cyclical.

Healthcare

Analysts consider healthcare to be one of the fastest growing industries in America. Spending, by some projections, is projected to grow by 5.8% annually for the next decade. The U.S. government estimates the industry will account for 20% of GDP by 2024, which is up from 17.4% in 2013. The full-fledged advent of the Affordable Care Act, or Obamacare, is only expected to contribute to this accelerated industry growth. The U.S. Census Bureau estimates that the population of citizens aged at or above 65 will nearly double to 83.7 million since 2012. This aging population, due mostly to the baby boomer generation, will also play a significant role in increased healthcare spending. In light of recent somewhat stagnant unemployment, rates [see Domestic]; the healthcare industry is leading the charge in job increases.

Recently, a few major healthcare providers are merging, such as Aetna and Humana and Anthem and CIGNA. This has the potential to significantly consolidated the health insurance sector, which could potentially alter the state of the entire industry. There are now potentially three major players in the sector: Anthem/CIGNA, UnitedHealth Group, and Aetna/Humana. These drastic changes will potentially increase bargaining power of insurance companies with other industries in the healthcare industry and reduce their profitability.

Despite this potential industry downside, the sector is starting contain an increasing number of growth stocks. Equity characteristics in the healthcare sector that the Fund should take into account is stability, both in the firm's balance sheets and the beta of the equity. Analysis of healthcare companies should be conducted with cautious optimism.

Utilities

Renewable energy has been increasing exponentially over the last decade. It is currently used to hedge fossil fuel risks and provide scalable, low-cost, and distributed power. According to the sector report by Deloitte Inc., wind power makes up 27% of new U.S. electricity capacity added since 2007, and is now ranked among the least expensive sources of new utility-scale generation. Likewise, solar power is gaining traction as the volume of distributed solar installation skyrockets, and major banks are competing to finance solar power projects. SolarCity Corp., the largest U.S. solar installer, has been doubling annual solar installations since 2010 and expects to surpass the one gigawatt mark in 2015. This high growth is partially fueled by the declining cost of solar system at 12% - 15% per year. The expansion of home solar power has the potential to be a major disruptor to electrical utility companies.

Utilities provide a stable income through dividends. If volatility in the stock market increases, the stability and safety of utilities should reduce some of the headwinds of the probable higher interest rates. In addition, utilities are considered to be a domestic play, as it is largely U.S. focused, and therefore will not suffer with a strong dollar. With the current uncertainty of interest rates, it is good to remain on the defensive, and dividend-paying utilities are an area the Fund should examine.

Conclusion

The U.S. economy is continuing to show greater signs of strengths than the global economy as a whole. The Federal Reserve is leaning towards a rate increase in their December meeting and gradual normalization of monetary policy afterwards. On the aggregate the domestic economic indicators point to continued positive economic growth. Europe is also showing signs of improvements of its labor markets. Due to the low inflation, the ECB is considering expanding its Quantitative Easing program, which will certainly lead to a further devaluation of the Euro. The transition in China from an export driven economy to a consumption driven economy has not been as smooth as hoped, as a result, investments in China should focus on equities that will benefit on higher consumption.