Our View on 2014: It's All Relative

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What is a value investor to do? We hear this common refrain from clients lamenting the lack of very cheap or very expensive assets in the current environment. Quantitative easing and accommodative global liquidity conditions have helped bid up assets across the risk spectrum. Looking forward, this raises two important investment considerations. The first is that markets will continue to be focused on monetary policy, particularly that of the U.S. Federal Reserve and its stated intent to reduce quantitative easing and subsequently raise policy rates. The second is that with nothing particularly cheap today, value investors are left to focus on relative value opportunities.

We have commented in various publications that given current valuations and a propensity for such valuations to strongly influence returns over seven- to ten-year horizons, we anticipate it will be harder to earn the common objective of 5% real returns over the next decade. As shown in Figure 1, should valuations, growth, and inflation conditions revert to more normal levels over the next decade (our Return to Normal scenario) the entire return continuum—assets ranging from inflation-linked bonds to EM equities and private equity investments—will be well below historical levels. At the same time, investors are generally being compensated for taking more risk, as the slope of our risk/return line for the Return to Normal scenario and equilibrium conditions is comparable.[1] Quite simply, all assets have been bid up.

While some investors would argue that bubbles are forming everywhere, we would counter that the use of the term bubble is itself in a bubble. For example, consider U.S. equities, the most expensive major equity market. Many analysts fret that U.S. equities are in a bubble, completely divorced from fundamental value. While we may ultimately get there, our analysis suggests that such equities are expensive, but not yet at levels that historically have spelled danger, and certainly not at bubble levels. Based on our composite normalized price-earnings (P/E) metric, U.S. equities appear about 30% overvalued, or roughly 1 standard deviation above fair value (Figure 2). Historically, valuations 1.5 standard deviations above fair value, which would require another 13% of price appreciation without an increase in normalized earnings, would mark the point at which we would start sounding warnings.

Looking ahead to 2014, we are focused on several key themes. On the macro side, we are monitoring the evolution of global monetary policy, and the impact that tightening in markets like the United States will have on various global assets. While concerned that tapering and higher rates may further impact a variety of assets like sovereign bonds and EM currencies, we are also watching what other central banks do. Further easing by the European Central Bank or Bank of Japan, for example, could help blunt the impact of potential Fed actions. Global growth is expected to accelerate in 2014, and another macro theme is how this translates into earnings growth across markets. On the equity side, we think the relative attractiveness of European and EM equities is worth highlighting. In Europe, faster growth should allow earnings to rebound from

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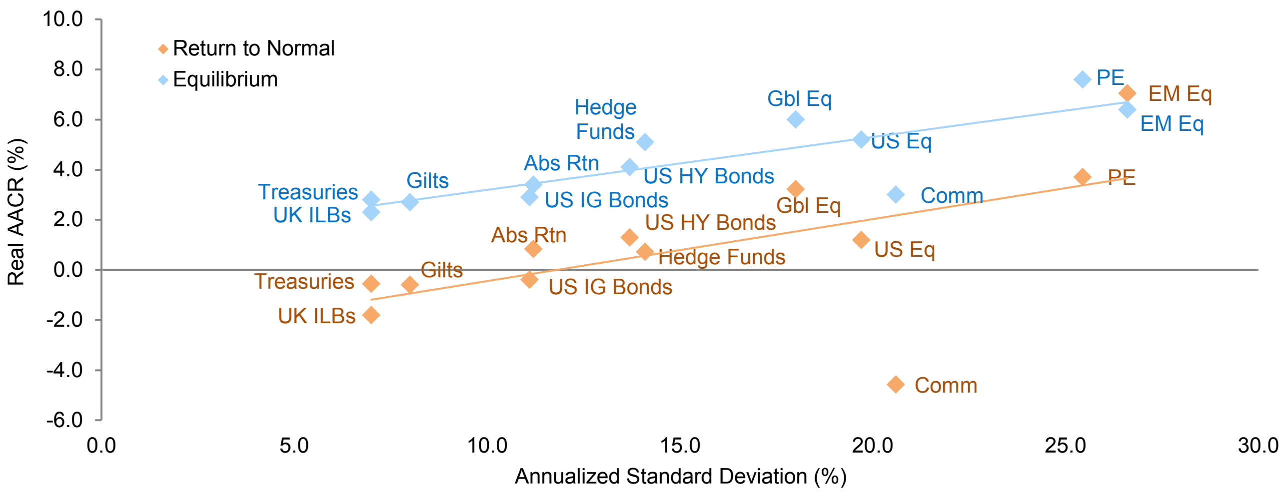
[1] For illustrative purposes, we assume that the standard deviation of all assets shown remains the same over the next ten years as our equilibrium assumptions. While we expect that standard deviations will almost certainly differ from our long-term expectations, we think that they provide a reasonable characterization of the relative volatility continuum of asset classes for these purposes.

Figure 1. Risk/Return Characteristics

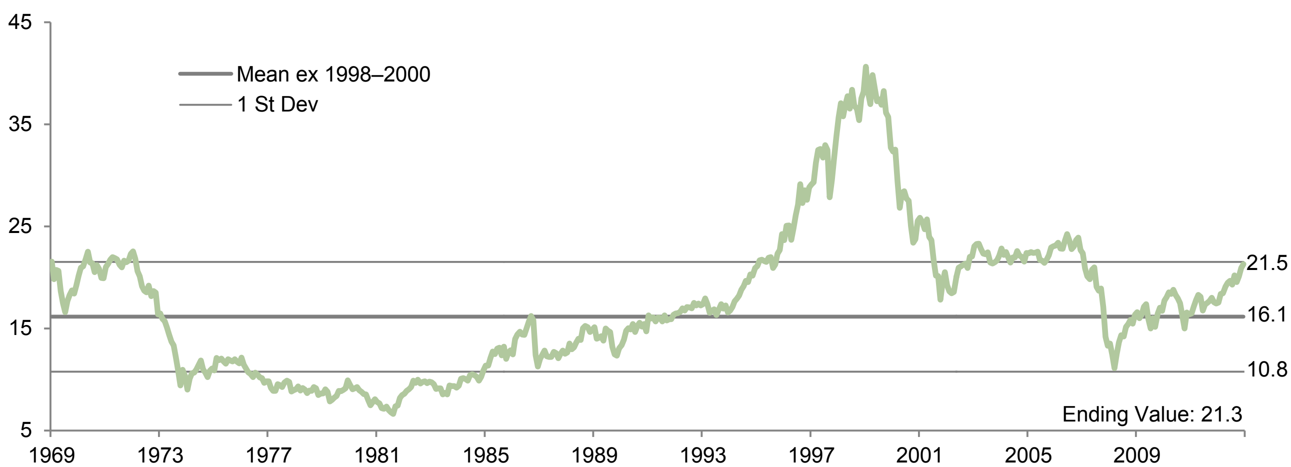
As of November 30, 2013



Source: Cambridge Associates LLC.
Notes: The Return to Normal projections are potential scenario returns given today's valuations, assuming mild inflation, moderate real earnings growth, a relatively low corporate default enviroment, a return to fair value ten-year Treasury yields, and normalized corporate spreads. Values for these assumptions are largely based on historical averages.

Figure 2. MSCI U.S. Composite Normalized P/E

December 31, 1969 – November 30, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. We have removed the bubble years 1998–2000 from our mean and standard deviation calculations. All data are monthly.

a low base, and given the valuation discount we recently advised an overweight relative to U.S. equities. We also continue to support a modest overweight to EM equities versus U.S. equities, but are aware of a number of risks such as a hard landing in China, overvaluation in consumer-focused sectors, and headwinds from balance of payments adjustments in some countries. As a result we advise investors to take a more nuanced approach, and favor active management over index-like exposures.

This commentary drills more deeply into a few of these themes and summarizes our advice. Relative value remains and we would lean into what is relatively cheap, but absent strong valuation opportunities and on the heels of a strong 2013, tempering expectations is appropriate. While most asset classes are not particularly cheap or expensive today, we would watch U.S. equity valuations carefully and be prepared to cut back sharply should valuations reach very overvalued levels. Further, we remain very cautious on credits today. They are overvalued, and subject to mark-to-market risk once rates ultimately rise.

Uncertain U.S. Monetary Policy Will Keep Investors Guessing

☞ **Long-term investors should position portfolios based on valuation head- and tailwinds.**

Sean McLaughlin

While few expect the Fed to take away the liquidity punchbowl soon with a tightening of policy rates, the central bank is likely to begin filling the punchbowl at a slower pace than today's $4 billion-per-day rate.[2] Early hints of QE "tapering" from Fed Chairman Ben Bernanke's testimony and presentations in May and June caused markets to convulse, re-pricing liquidity-drunk asset markets in short order. The yield on the ten-year Treasury shot from 1.66% at the beginning of May to 2.60% by late June. Among the hardest-hit assets: EM equities, debt, and currencies; bonds of all stripes; commodities; and real estate and other yield-oriented equities (Figure 3).

After mid-September, when the Fed surprised investors by continuing bond purchases at the current rate, asset prices regained some of the ground they had lost (and bonds continued to run up in the wake of the debt-ceiling standoff). But this may well be a temporary respite. As employment and consumption in the United States continue to improve, the Fed will likely begin scaling back bond purchases in coming months (though it faces little pressure to do so quickly given that current conditions are not strong and inflation expectations remain low—see Figure 4). While bonds and other assets that suffered in the "taper tantrum" of May and June remain less expensive now than they were in early May, they are likely somewhat vulnerable when the Fed eventually moves to shrink its massive ongoing stimulus. The hurricane has not gone out to sea, though it may have lost a bit of energy as it takes longer than expected to reach shore.

The eventual Fed decision to reduce bond purchases is likely to be announced long before any decision to raise policy interest rates. While Fed Funds futures markets have already incorporated some expectations of rate tightening, the amount of tightening baked in is low and the expected timing is distant. As of early December, the market-implied Fed Funds rate was about 50 basis points (bps) two years hence. Before the Fed's September no-taper surprise, the market-implied expectation was that Fed would pass that 50 bp threshold about nine months earlier; the delayed expectations for policy-rate hikes were likely a significant factor in the nearly 4% return for ten-year Treasuries and 7% for EM bonds[3] over that six-week period.

Continued uncertainty over the timing of Fed liquidity reduction (tapering and tightening) is likely. The Fed is soon to be helmed by a new chair (current vice-chair Janet Yellen is awaiting Senate confirmation for the role), and the bank's policy-making Open Market Committee (FOMC) may worry about the degree to which this fall's economic data was distorted by the debt-ceiling standoff.

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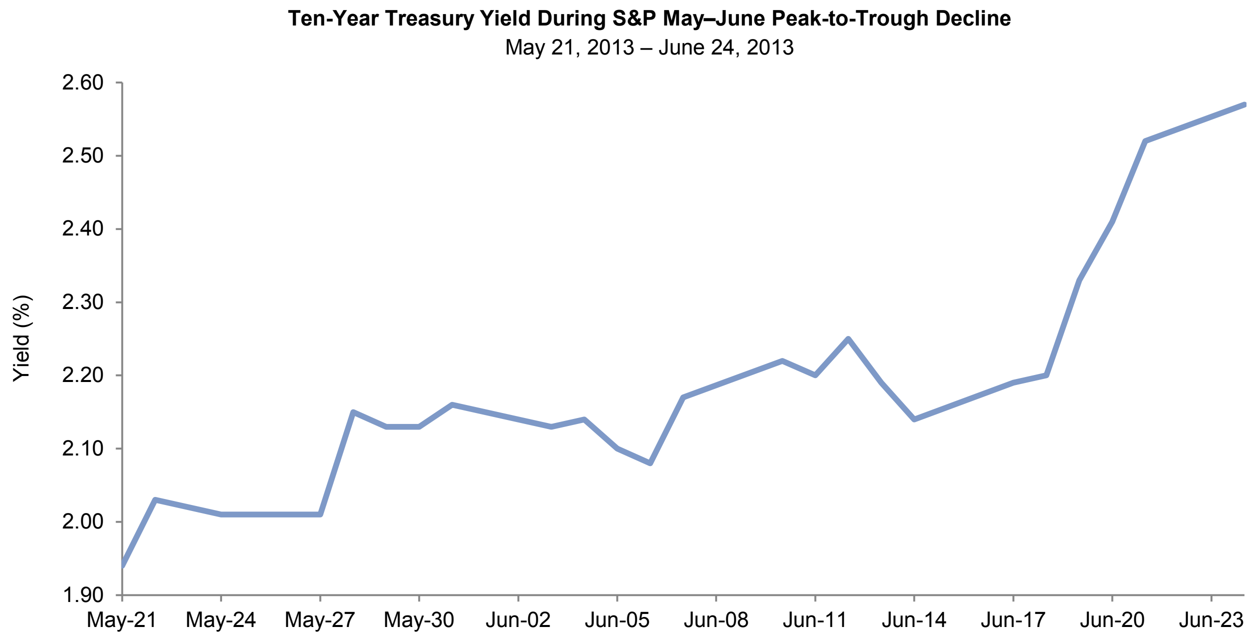
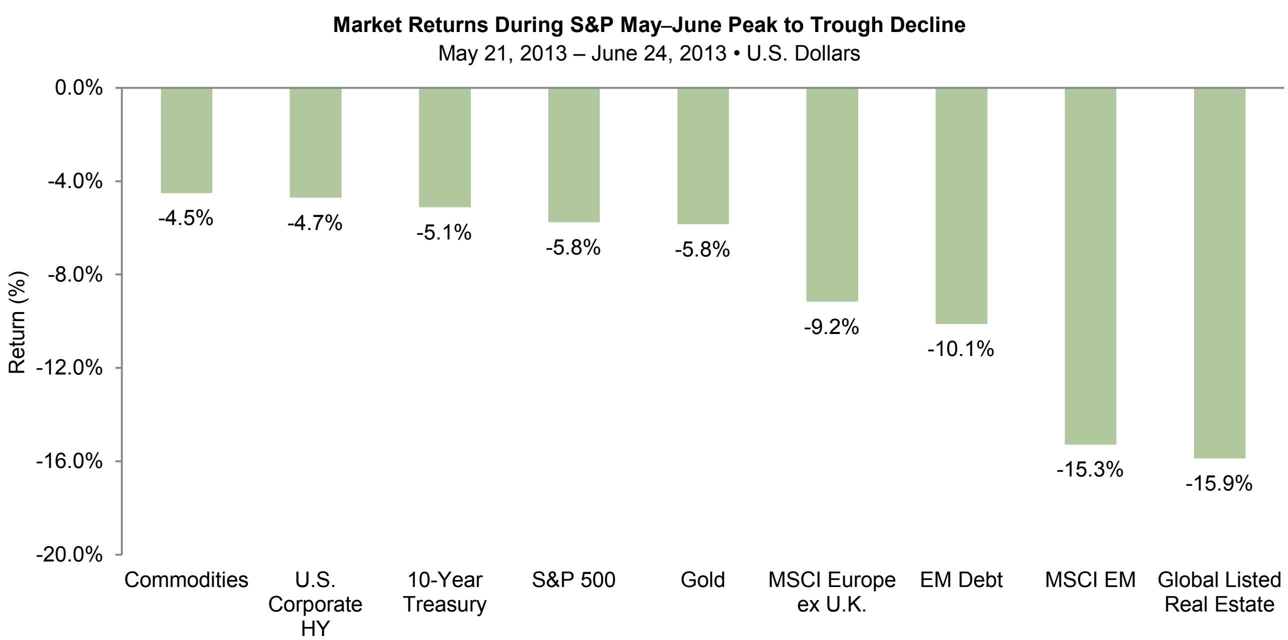
[2] Four billion dollars per day refers to the Fed's target of $85 billion in MBS and Treasury bond purchases per month, divided by the roughly 21 days per average month when the bond market is open.

[3] Refers to the JPMorgan GBI-EM Global Diversified Index, in US$ terms.

Figure 3. The Fed's Influence: Performance in May and June 2013

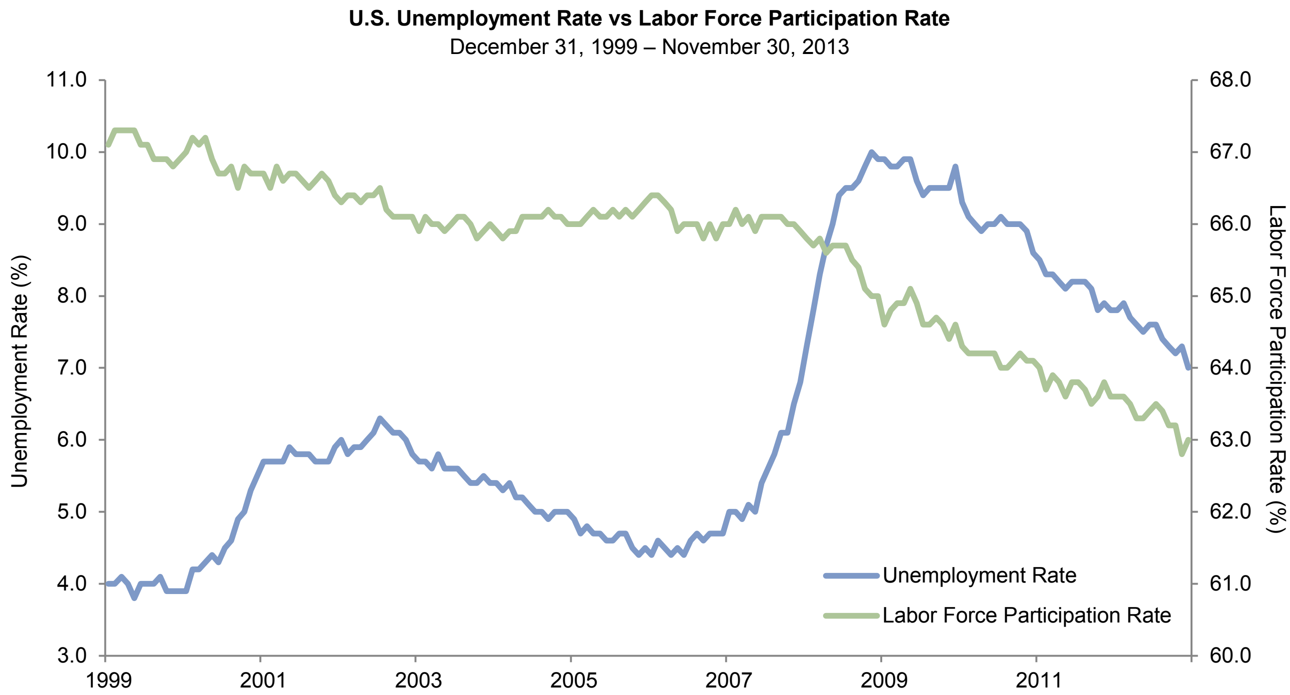


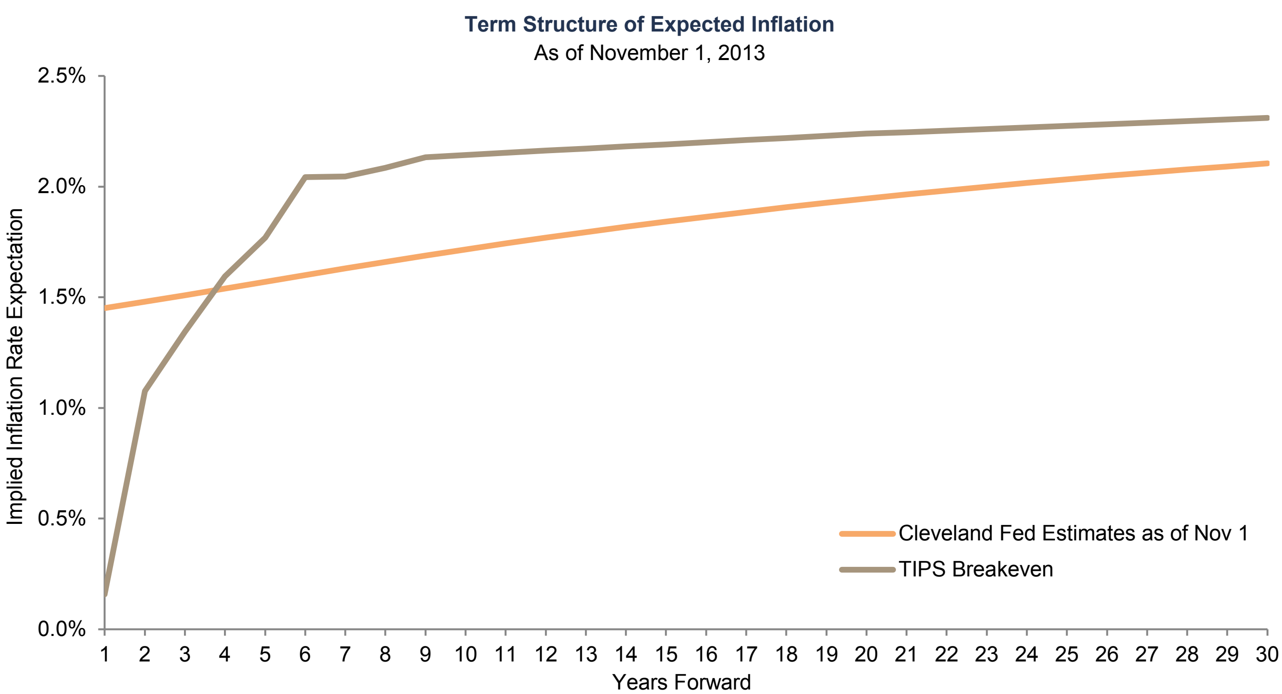


Sources: Barclays, Credit Suisse, Dow Jones Indexes, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: EM debt represented by the J.P. Morgan EMBI Global Diversified Composite Index, U.S. corporate HY represented by the Barclays Corporate High Yield Index, global listed real estate represented by the FTSE® EPRA/NAREIT Global Index, and commodities represented by the DJ-UBS Commodity Index.

Figure 4. Unemployment and Inflation





Sources: Bloomberg L.P., Federal Reserve Bank of Cleveland, and Thomson Reuters Datastream.

In addition, inflationary pressures seem distant,[4] the recovery in the labor market remains weak and workforce participation has dropped to a 35-year low, the housing recovery has proven to be somewhat sensitive to rising mortgage rates, and political dysfunction in Washington may encourage the Fed to be more dovish than it might normally like. Still, given most professional economists got the September no-taper decision wrong, it seems unlikely that many investors will be consistently successful in determining whether the market's baked-in tapering and tightening expectations are too dovish or hawkish.

Potential Impacts

As investor expectations for the timing of liquidity withdrawal change, asset prices will respond. However, the direction and degree of those changes may be partly dependent on the strength of economic growth. For example, if the Fed keeps liquidity flowing as growth steams upward, then that would imply a much different set of winners and losers than if the spigot remained open because growth was deteriorating (Figure 5).[5]

[4] U.S. consumer prices rose just 1.0% over the 12 months ended in October.

[5] Readers will notice that Figure 5 only addresses publicly quoted asset classes, and leaves out hedge funds and private investments. This stems from the many nuances of these asset classes as well as the high level of intra-category manager performance dispersion. Given those issues, calibrating potential return head/tailwinds for these categories across this liquidity/growth matrix may be folly. That said, we believe that under the very broad hedge fund umbrella, arbitrage-oriented strategies might hold up well in those environments on the left side of the page that are challenging for equities because of the boost in yield on the high cash-collateral balances common in these strategies. Given the multi-year investment periods of many private strategies, for funds raising capital today, the impact of liquidity reduction during the investment period may be a mixed bag (it's anyone's guess what the liquidity environment will be

Figure 5. Potential Winners and Losers as Fed Liquidity Withdrawal Expectations Change

Given the many uncertainties (*timing* and *scope* of liquidity reduction, *level* and *direction* of growth and inflation), we suggest investors with a long time horizon focus on valuations.

		More Rapid Tightening with			Slower Tightening with		
	Current Valuation	Higher Nominal Growth	Stable Growth	Decelerating Growth	Higher Nominal Growth	Stable Growth	Decelerating Growth
U.S. Equities	OV	?	–	–	+	+	–
Non-U.S. DM Equities	FV	?	–	–	+	+	–
EM Equities	FV	?	–	–	+	+	–
EM Debt (LC)	FV	–	–	–	?	+	?
Commodities	OV	?	–	–	+	+	–
U.S. Treasuries	OV	–	–	–	–	+	+
U.S. TIPS	OV	–	–	–	?	+	+
Leveraged Loans	OV	+	+	–	+	?	–
U.S. Dollar	UV*	+	+	?	?	?	–

Note: Current valuations are as of our December 6, 2013, valuation matrix.
* U.S. dollar is undervalued versus developed markets currencies.

We expect that the Fed's eventual liquidity withdrawal, if it comes while the economic growth environment remains lackluster but stable, will likely pressure the prices of both risk assets and of bonds. Within equities we expect that, *ceteris paribus*, yield-oriented assets (including dividend-focused strategies, master limited partnerships, REITs, and minimum volatility equity strategies with hefty utility sector exposure) will face some of the greatest headwinds in an environment of tapering and eventual tightening, because prices will need to adjust for yields to remain competitive with bonds and cash. Within credit and bonds, we expect that high-quality, long-duration bonds will face significant headwinds, but lower-quality credits could also face pressure, as investors that were forced to reach for yield no longer face that need.[6]

However, even that result is far from guaranteed. As Figure 6 highlights, the winners and losers during periods of Fed tightening have been maddeningly inconsistent; bonds actually outperformed other asset classes during two of the periods shown, and real assets were a mixed bag. During periods of rising Treasury yields, the impact on *bond* total returns is much more predictable, of course, but returns for other asset classes remain inconsistent.

Why would asset class returns be so all-over-the-map during environments of rising rates and yields? Several factors are probably at work: (1) some level of expected tightening may already have been priced in to asset valuations at the beginning of the period; (2) the levels and trajectory of growth and inflation during the various time periods differed; and (3) asset classes vary in their exposure to factors other than interest rates (e.g., T-bill returns are a one-trick pony, while REIT returns are influenced by interest rates, credit conditions, inflation, economic growth, and other factors).

The timing of Fed liquidity reduction is up in the air as well, as discussed earlier. In the face of such uncertainty, our recommendation is likely familiar: rely on valuations, and recall that one of the comparative advantages for long-term investors is the flexibility to focus on long-term valuation headwinds and tailwinds, allowing short-term macroeconomic noise to work itself out.

Summary

Looking across asset classes that should be particularly sensitive in the short term to changing expectations about tighter monetary policy, we offer some valuation-centered advice:

- Bond valuations have improved substantially since April, yet most categories remain overvalued. If ten-year U.S. Treasuries returned to their fair value yield of 3.75%,[7] prices of those bonds would decline by roughly 8%. This view must be balanced by the opportunity cost of near-zero cash yields, and the fact that inflation remains low. But on balance, we remain supportive of keeping a portion of the portfolio's policy allocation to Treasuries and other high-quality sovereign bonds in cash until valuations improve. For U.S. taxable investors, on the other hand, municipal bonds

several years from now when these funds eventually begin to harvest those investments).

[6] High-yield bonds currently offer a yield of just 5.60%; this would equate to a loss-adjusted yield of roughly 3.60% based on the asset class's historical annual default loss average. Only in an environment of very low Treasury yields does this expected return look remotely reasonable; boost the Treasury yield and it's likely that required yields on credit will rise as well. We would not rule out the prospect of some spread compression, but spreads today are not particularly wide.

[7] We estimate fair value as the average level of nominal GDP growth over the past ten years.

Figure 6. Asset Class Returns During Periods of at Least 200 Basis Point Increases

		Months	Increase (bps)	T-Bills	Ten-Year Govt Bonds	U.S. Equities	World ex U.S. Equities	REITs	Natural Resources Equities	Comm
Periods When Target Fed Funds Rates Increased by 200 bps or More										
3/1/1972	to 6/30/1974	28	700	16.35	4.27	-13.20	4.56	-14.60	N/A	149.44
8/1/1977	to 3/31/1980	32	1,175	24.97	-8.66	18.39	51.16	53.43	106.97	87.78
10/1/1980	to 2/28/1981	5	650	5.70	-3.54	6.60	-2.41	9.44	-5.64	-14.41
5/1/1981	to 6/30/1981	2	350	2.64	3.68	-0.43	-3.51	1.94	-7.23	-5.85
2/1/1982	to 4/30/1982	3	200	3.49	5.06	-1.74	-6.55	-0.59	-11.60	5.05
3/1/1984	to 8/31/1984	6	344	5.40	2.30	8.87	-2.46	1.87	-5.47	1.50
3/1/1988	to 5/31/1989	15	331	9.80	8.64	25.32	13.23	10.12	24.90	43.50
2/1/1994	to 6/30/1995	17	300	7.03	6.51	17.80	1.99	5.97	7.12	-2.62
6/1/2004	to 8/31/2007	39	425	12.89	16.96	39.65	83.69	79.81	154.88	13.97
Periods When Ten-Year Treasury Yields Increased by 200 bps or More										
4/1/1967	to 12/31/1969	33	338	16.45	-4.97	11.29	N/A	N/A	N/A	N/A
6/1/1972	to 4/30/1975	35	226	22.23	4.72	-11.21	4.41	-7.23	N/A	145.88
1/1/1977	to 2/28/1980	38	591	27.47	-10.00	23.80	79.30	99.62	159.87	104.17
7/31/1980	to 9/30/1981	15	575	17.63	-14.60	8.10	-6.11	13.26	-14.43	-9.94
5/1/1983	to 5/30/1984	13	364	10.76	-7.66	-4.02	10.70	12.72	10.10	17.43
9/1/1986	to 9/30/1987	13	268	6.54	-8.71	31.33	44.24	5.73	71.28	26.95
10/1/1993	to 11/30/1994	14	251	4.49	-10.02	2.15	8.04	-10.95	17.76	-8.49
10/1/1998	to 1/31/2000	16	224	6.46	-8.95	39.44	44.73	-7.10	28.02	24.32

Sources: BofA Merrill Lynch, Federal Reserve, FTSE International Limited, Global Financial Data, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: U.S. Equities represented by S&P 500, World ex U.S. Equities represented by MSCI World ex U.S., REITs represented by FTSE® NAREIT All Equity REITs, and Commodities represented by S&P GSCI™. Natural Resources Equities represented by 80% Datastream World Oil & Gas and 20% Datastream World Mining.

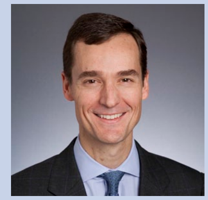
are currently fairly valued, and we would hold them at a neutral weight.

- EM assets are vulnerable not just to Fed liquidity reduction, but also to any credit-market dislocation or continued slowdown in China. However, we believe that a full-fledged EM currency crisis is unlikely. While certain countries have poor current account positions, levels of external debt are lower than in the late 1990s, levels of foreign exchange reserves are higher, and outright currency pegs are rare. EM bonds are fairly, but not compellingly, valued. EM equities, on the other hand, are at the attractive end of fairly valued and we would continue to overweight them versus pricey U.S. equities.

Valuations are unlikely to provide much support against strain from unwinding of Fed liquidity, but for investors that can look through shorter-term volatility, the liquidity unwind does not have to push them away from a valuation focus.

Europe Will Finally Exceed (Diminished) Expectations

We expect earnings and macro developments in 2014 to confirm our advice that investors overweight European equities relative to U.S. equivalents.



Wade O'Brien

Despite disappointment on the earnings front, European equities generated strong returns in 2013 given unchallenging valuations and diminished macro fears. Nonetheless, Europe has lagged other developed markets like the United States and Japan over most recent trailing timeframes (Figure 7), and now trades at a close-to-record discount relative to DM peers (Figure 8). We recently recommended investors overweight European equities relative to U.S. equivalents[8] given favorable relative valuations, earnings that should improve from a low base, and a stabilizing macro situation. Looking ahead to 2014, companies will need to finally deliver on earnings expectations given higher valuations, but there are reasons for optimism.

The Micro: Earnings and Sector Outlooks

Defying forecasts, European corporate earnings are likely to contract for a second straight year in 2013, given weak economic growth both in the region and in key export markets. As a result, the bar is now lower for 2014, relative to both emerging and other developed markets. European earnings currently sit 30% below 2007 year-end levels, while earnings in the United States and emerging markets have recovered and reached new peaks (Figure 9). Recent consensus estimates are for earnings growth of 13% in 2014, driven by various forces including stronger economic growth, which boosts operating leverage and lifts margins. Profit margins in Europe, which sit at around 50% of U.S. equivalents, suggest ample scope for mean reversion between the two regions.

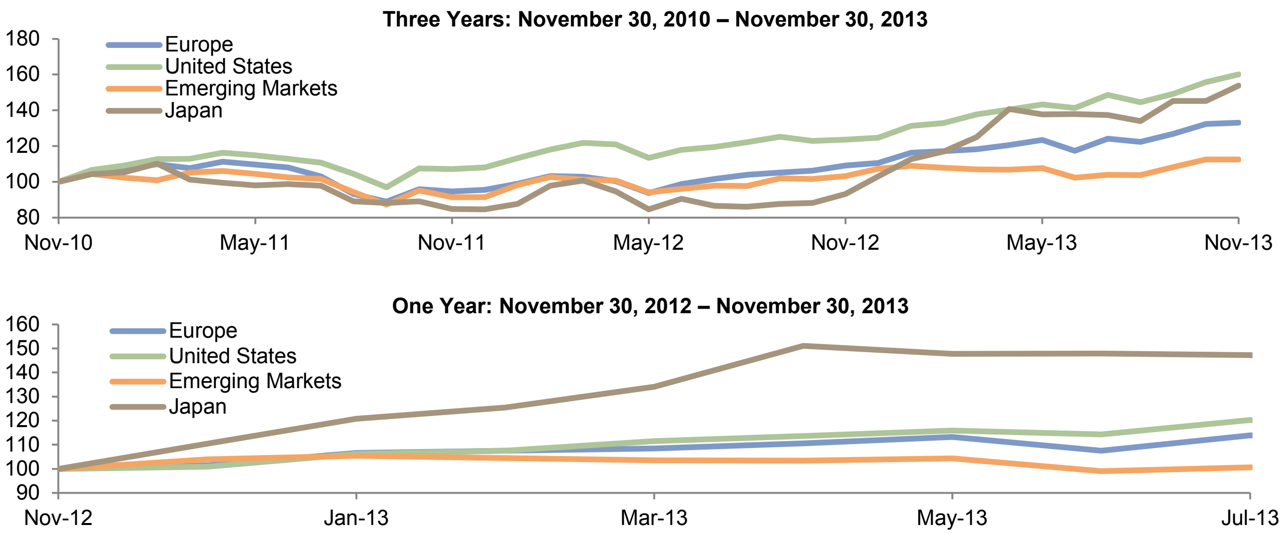
The European financial sector is key to this earnings recovery. Even if they grow the expected 22% in 2013, financial earnings will still be down around 64% since the end of 2007. Expected growth of 17% for 2014 also seems reasonable in this context, but the sector faces a variety of headwinds. Regulatory changes are forcing banks to hold more capital and penalizing them for holding riskier assets, and many institutions have yet to deleverage. Loan defaults could rise among highly leveraged companies if economic growth continues to contract. Rising borrowing costs could impact profits if short-term tools like the long-term refinancing operation are scaled back or credit investors grow wary of the potential for bank liabilities to absorb losses under new bank resolution proposals. As the European Central Bank moves into the role of regulator for the Continent's largest banks in 2014, it will conduct stress tests that may reveal further capital shortfalls. A system for recapitalizing weaker banks is not yet fully in place, and forced capital raisings could spur market sell-offs.

Yet all is not gloom and doom for European banks and some of the headwinds mentioned above seem priced in to current valuations. At just 1.0 times book value, banks trade at a 40% discount to the overall MSCI Europe Index

[8] Please see our October 2013 Market Commentary *European Equities: Time to Focus on the Micro.*

Figure 7. Cumulative Wealth of European Equities Compared to Other Markets

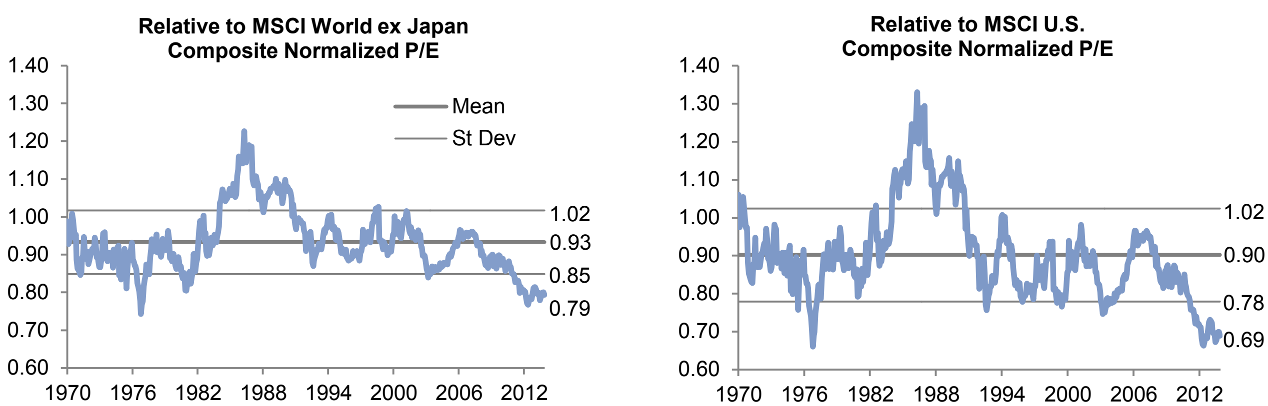
Local Currency



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Top chart rebased to 100 on November 30, 2010; bottom chart rebased to 100 on November 30, 2012.

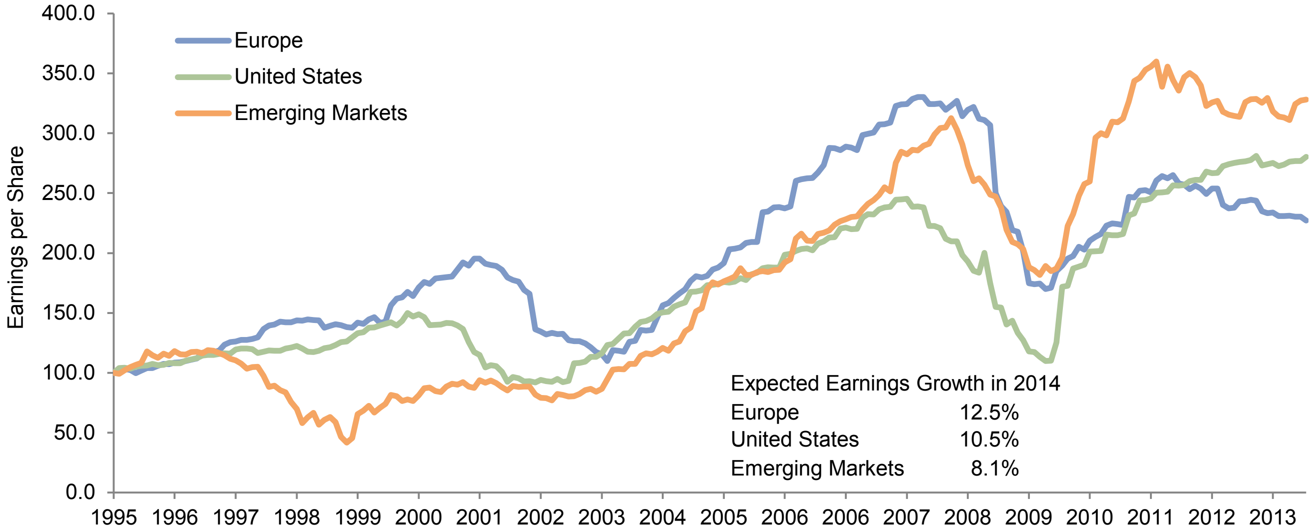
Figure 8. Relative Valuations for MSCI Europe

January 31, 1970 – November 30, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression.

Figure 9. Earnings per Share Across Regions
December 31, 1995 – November 30, 2013

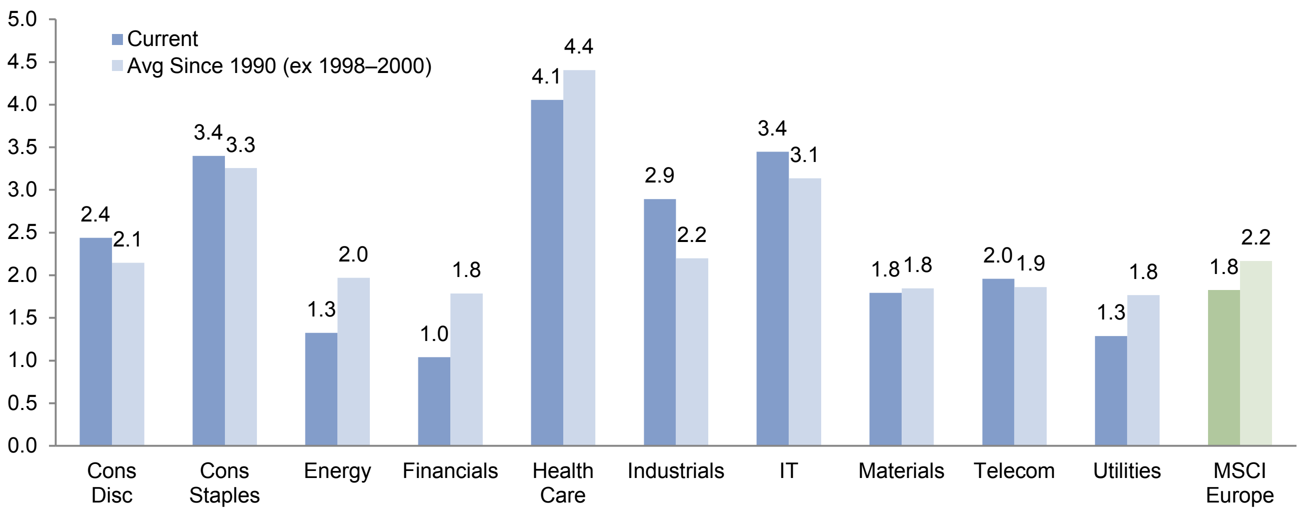


Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Earnings rebased to 100 on December 31, 1995. Emerging markets and U.S. data in US$ terms; European data in local currency.

and well below the historical average (Figure 10). A substantial amount of deleveraging by financials has occurred in countries such as the United Kingdom and Switzerland, and many of the strongest institutions have already raised capital. Potential losses from weakening loan books may also be better understood and provisioned for than assumed. For example, the IMF recently noted that under a more adverse scenario where Spanish, Italian, and Portuguese banks suffered €250 billion of losses on non-performing loans over the next two years, existing provisions would cover roughly 75% (€190 billion), with expected profits and capital buffers covering the rest. From a cyclical perspective, stronger economic growth may encourage credit creation and improve credit quality. Funding costs have also fallen this year, which should flow through to bottom lines. The U.S. experience, where concern also existed about a "structural" lack of profitability after the housing crisis, may provide a template on how provisioning, earnings, and sentiment might inflect in Europe—Eurozone bank provisioning is currently at its highest level in at least 15 years, according to data from J.P. Morgan.

Other cyclical sectors also would need to see earnings improve in 2014 for European equities to outperform. Energy sector earnings are expected to decline roughly 15% in 2013 and currently sit 21% below 2007 levels, weighing on performance and valuations—the sector trades at a significant discount to the overall index on both a forward P/E (10) and price-to-book (1.3) basis. A variety of forces have buffeted earnings, including operational problems (BP) and the risks of reaching ever farther geographically (Repsol) or technologically (Total) for reserves. Despite the lower bar, the 13% expected earnings growth for

Figure 10. MSCI Europe GICS Sector Price-to-Book Ratios
As of November 30, 2013



Sources: FactSet Research Systems, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data prior to January 31, 1995, are sourced from FactSet.

2014 is on par with the overall index. Some previous problems have been addressed, and going forward free cash flow (and perhaps fund dividends or buybacks) may improve as capex tapers off and lower borrowing costs boost margins. Earnings for the materials sector have also posted significant declines since 2007, given the slowdown in emerging markets and various operational difficulties. The 20% growth expected in 2014 may seem aggressive at first glance, but given the expected 14% decline in 2013, such an estimate may prove easier to beat than meets the eye.

Away from the cyclical sectors, more defensive sectors boast higher valuations, but earnings expectations do not seem outlandish. The consumer staples sector trades at a premium on both a forward P/E and P/B basis, but expected earnings growth of 8% is below that for the overall index. Similarly, consumer discretionary stocks also trade at a slight premium, but the 12% earnings growth expected in 2014 should be viewed in the context of an expected 13% decrease in earnings during 2013. Both of these sectors earn a significant percentage of their revenue streams from outside Europe, which should provide a buffer if economic growth disappoints.

The Macro: Stronger Growth and Reduced Sovereign Debt Stress

European equities would benefit from stronger earnings, but may struggle to outperform if the fragile economic recovery that has recently taken root can't gather steam going into 2014. Consensus expectations for real GDP growth in 2013 have dropped across the region for several quarters. A slight decrease for the Eurozone is now the base case, with stronger growth expected in the United Kingdom

(1.4% year-over-year) and Switzerland (1.8%). Looking ahead, expectations for Eurozone GDP growth in 2014 remain fairly muted at just 1.0%, though the United Kingdom, Switzerland, and the Nordic countries should see growth above 2%.

Domestic and external factors could drive stronger economic growth. Within the Eurozone, austerity measures should ease and credit may stop contracting, boosting activity and thus operating leverage. Roughly 40% of overall European corporate revenue comes from outside of Europe, based on data from Goldman Sachs, though the number is above 50% for non-Eurozone countries (like the United Kingdom and Switzerland), which account for 54% of the MSCI Europe Index. These export-oriented companies will also need to see growth improve in key markets like China and the United States; this seems likely but is not guaranteed given concerns over a credit bubble in the former and political dysfunction in the latter.

For European equities to continue their recent trajectory, concerns over sovereign debt levels must remain contained. The ECB's suggestion last summer that it would use Outright Monetary Transactions (OMT) to stabilize bond markets of qualifying countries caused yields on peripheral sovereign bonds to plunge and greatly reduced the risk of default (as well as Eurozone breakup). Lower sovereign yields improve debt sustainability, but debt levels are still too high in some countries and further restructuring in countries like Greece (and perhaps even Portugal) can't be ruled out. Peripheral countries have exceeded expectations in 2013 with respect to closing current account deficits and reducing labor costs, though at the cost of reduced imports and near-record-high unemployment, which has caused pervasive popular discontent. Similarly, fiscal deficits have narrowed, but reduced government payrolls have been unpopular and many countries have had deficit reduction targets pushed back. If political or market tensions again rise, ECB Chairman Mario Draghi may need to deliver on his pledge of doing "whatever it takes" to preserve the Eurozone and show that bond purchases will work as promised. A separate political risk may be the rise of far-right political parties that are opposed to further economic and political integration, though at this point these parties seem to have divergent views and their support may fade if economic growth continues to recover.

Overall *European* debt levels compare surprisingly well with international peers, tempering our concerns over *peripheral* sovereign debt. Gross government debt/GDP in the United Kingdom and Eurozone stand at 90% and 93%, respectively, versus 107% in the United States and more than double that in Japan (Figure 11). Bank leverage is higher in Europe, but this can partly be attributed to international activities and different models for financing housing across markets. We are less concerned than some about how deleveraging may impact activity and thus corporate profits, but recognize political winds can shift and would reconsider our position should the dovish monetary policy (i.e., low interest rates) that facilitates such leverage change. The greater macro risk for Europe may be easing pressure for structural reforms in areas like labor law, given that sovereign bonds are no longer in the crosshairs of investors. A lack of structural reform could reduce competitiveness going forward, limiting profits and growth in many European countries.

Figure 11. Global Macro Snapshots
2012–13

	Gross Gov Debt (% of GDP) 2012	Household Debt (% of GDP) 2012	Budget Surplus/Deficit (% of GDP) 2012	Budget Surplus/Deficit (% of GDP) 2013	Current Unemployment Rate (%)	Current Account Balance (% of GDP) 2012
United States	106.5	79.9	-8.5	-5.8	7.0	-3.0
United Kingdom	90.3	94.0	-8.3	-6.1	7.6	-3.5
Japan	237.9	63.9	-10.2	-9.5	4.0	1.0
Eurozone	92.9	98.6	-3.6	-3.1	12.1	1.8

Sources: International Monetary Fund and Thomson Reuters Datastream.
Notes: Budget surplus/deficit figures for 2013 are IMF projections. Current unemployment rates are as of November 30, 2013, for the United States, September 30 for the United Kingdom, and October 31 for Japan and the Eurozone.

Summary

The 20% rally in European equities year-to-date has run ahead of improvement in underlying earnings, though valuations going into 2013 were undemanding. Growth has also disappointed. However, recent data look more promising and structural imbalances are being addressed. Looking ahead to 2014, valuations closer to historical averages suggest companies only need to deliver on fairly muted earnings expectations. The macro picture also needs to continue showing improvement, though again the picture outside the Eurozone looks more robust, and the troubled peripherals are a fairly small percentage (<10%) of overall market capitalization. We remain constructive on Europe relative to U.S. equities given relative valuations and the earnings cycle, and encourage investors to increase exposure.

Emerging Markets Face Headwinds, Balanced by Attractive Valuations Across Vulnerable Sectors

☞ **While modest overweights to emerging markets are sensible, headwinds remain in the near term and investors should not expect a repeat of the massive EM outperformance over 2003–2007.**

Aaron Costello

The huge performance gap between EM and DM equities in 2013 creates the possibility of a near-term pop for badly lagging emerging markets, but in the intermediate term, EM equities face several headwinds that make a repeat of the 2003–07 bull market unlikely. At the same time, performance of individual countries and sectors within emerging markets may continue to diverge, creating opportunities for nimble non-index-type exposures. Given that emerging markets remain an important part of the global economy and global equity markets, investors need to take a more nuanced approach to investing, evaluating sector and country exposure. While current valuations should eventually normalize and allow emerging markets to outperform over the long run, today we would suggest only modest overweights.

2013 Performance

It's certainly been a tough year for emerging markets. Though EM equities have rallied recently, they remain flat for the year in US$ terms while DM equities have returned over 20%, resulting in one of the largest performance gaps since 1998. At the same time, EM fixed income and currencies were hit hard amid the general sell-off in bond markets referenced earlier.

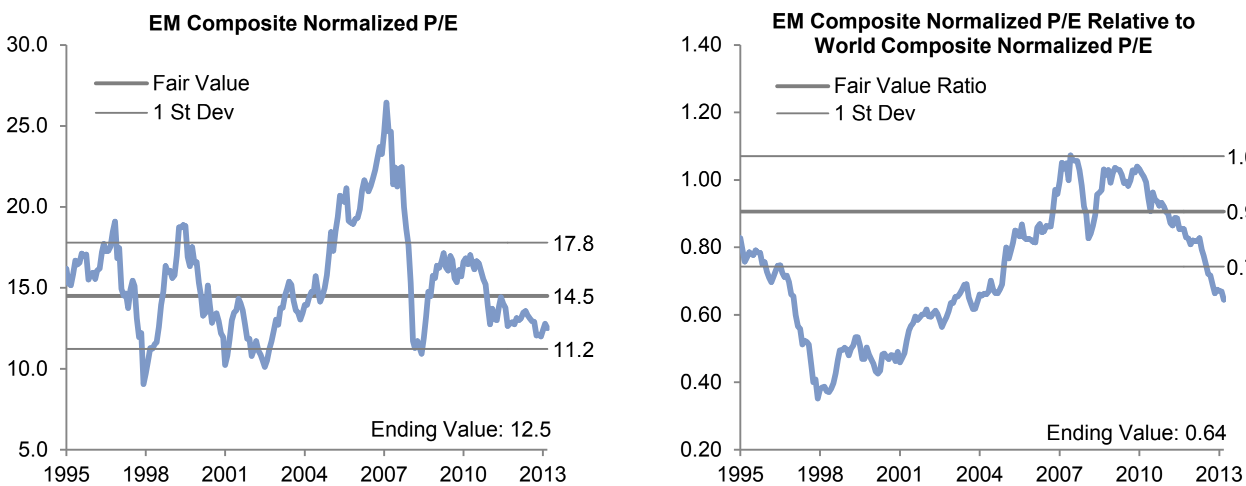
The poor performance of EM equities stems largely from macro concerns over slowing growth, especially in China, and its impact on commodity prices and earnings. At the same time, growth is improving across developed markets, including Europe and Japan. Add to that the prospect of an end to QE and a stronger U.S. dollar, and investors have clearly pulled away from EM assets broadly in favor of developed markets.

The underperformance of EM equities amid a strong global equity rally caught most investors off guard. When global economic cycles are in sync—over 2003–07, for example, or 2008–09 when global growth cratered and rebounded—emerging markets have outperformed. Today, the EM and DM cycles are diverging.

Though most striking in 2013, this bout of EM equity underperformance dates to late 2010, when the Fed launched the second round of quantitative easing. Late 2010 also marked the start of EM monetary tightening in response to rising inflation and asset bubble concerns following strong growth—for example, China began to cool its economy after its massive stimulus program in 2009. At the same time, EM equity valuations commanded high premiums over developed markets, leaving the asset class vulnerable to a change in fundamentals (Figure 12).

Even as EM equities as a whole have lagged DM equities and now trade at a wide valuation discount, performance within EM sectors and countries is diverging due to differences in underlying fundamentals. In other words, emerging markets no longer trade like the single, high-beta asset class they were for most of the past decade.

Figure 12. Emerging Markets Valuation
September 30, 1995 – November 30, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings.

Valuations: Not So Clear Cut

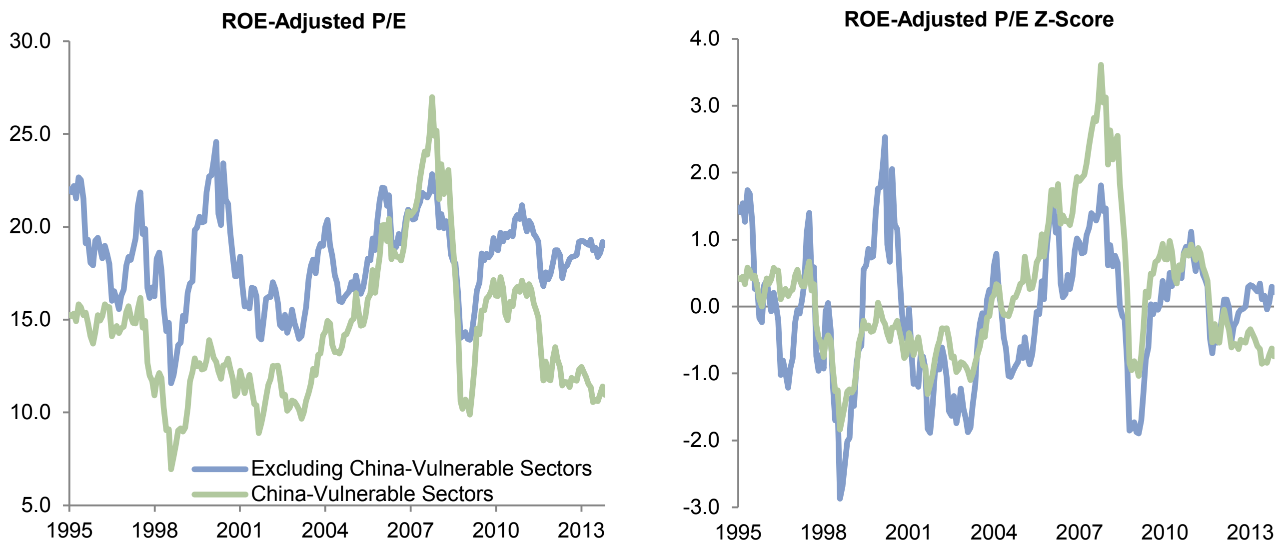
A key driver of the divergence among emerging markets is the degree of perceived exposure to China's planned economic rebalancing away from investment-driven growth. While the EM index trades at below average valuations compared to history, this undervaluation is concentrated in the energy, materials, and financial sectors, which together account for 50% of the index. Commodity-related sectors appear cheap given questions about Chinese demand and investor disdain for state-run companies with poor governance. Financials appear cheap given the heavy exposure to Chinese bank stocks. The big Chinese banks are trading near book value, highlighting market concerns over the quality of their balance sheets.

At the same time, EM consumer-related stocks and sectors are trading at above-average valuations; there's even talk of a bubble in EM consumer staples stocks, which are near all-time high valuations. Anything less exposed to slowing Chinese growth has been a relative haven and is not cheap. On a sector-neutral basis, EM equities appear fairly valued. While the China-vulnerable sectors of energy, materials, industrials, and financials are on average 20% below fair value, the remaining sectors are on average 3% *above* fair value (Figure 13).

Across EM countries we see a similar trend: those markets deemed "domestic demand driven" and less exposed to China have done well recently. This includes much of Southeast Asia,[9] which had been the brightest spot in emerging markets until the outbreak of currency troubles this summer. EM small caps

[9] Indonesia, Malaysia, the Philippines, and Thailand are included in the MSCI EM Index.

Figure 13. Emerging Markets Sectors: ROE-Adjusted P/E
January 31, 1995 – November 30, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied
Note: China-vulnerable sectors are energy, financials, industrials, and materials.

and frontier markets also benefited from the "domestic demand" theme in 2013.

Since the mini-panic over Fed tapering this summer, investors have increasingly incorporated currency risk premiums for markets such as Brazil, India, Indonesia, South Africa, and Turkey, given weaker current account dynamics. These countries also face higher inflation and the impact of rising rates on growth, which may depress market returns.

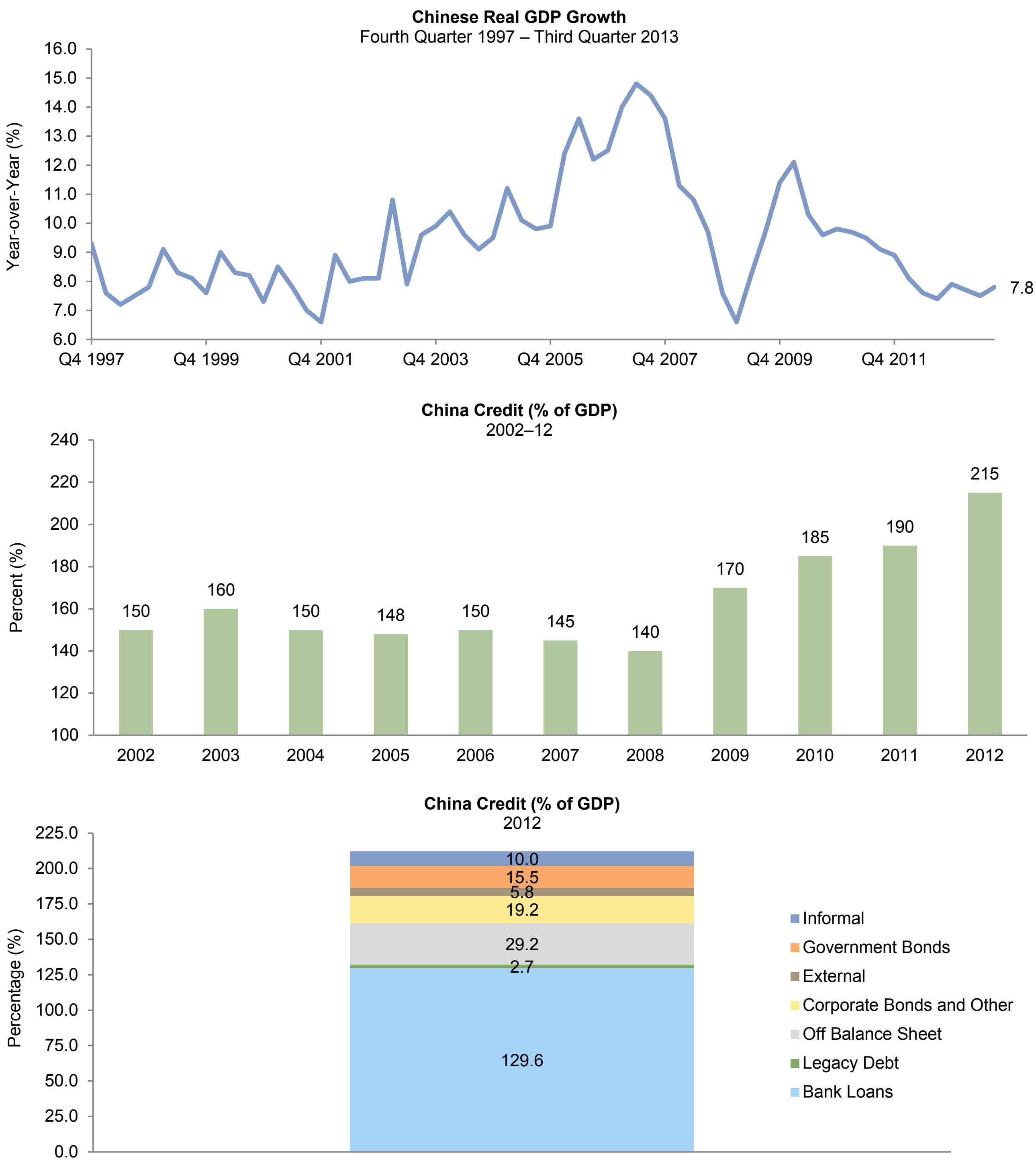
China Hard Landing: The Key Risk

China is the big question mark and the big risk for emerging markets. A hard landing in China could trigger a wider EM crisis and send fund flows back toward developed markets, echoing the aftermath of the 1997 Asia Crisis. Recent data suggest the Chinese economy is stabilizing after slowing more than expected early in 2013. This stabilization, alongside the Fed's decision to delay tapering, has helped trigger the recent bounce in EM equities.

While near-term concerns over a hard landing in China have abated, we remain concerned about the increase in the country's debt levels. China's investment-driven growth model of the past decade, especially the stimulus over 2009, has resulted in an accumulation of misallocated capital and potential bad debts in the financial system (Figure 14). GDP growth has slowed from about 10% in 2011 to 7.8% recently, accompanied by an increase in debt levels equivalent to 215% of GDP—up from 150% before 2009. In other words, the rapid increase in debt has not boosted growth, implying much of the increase in credit has gone into unproductive uses, or simply refinanced existing debt.

Chinese authorities are trying to achieve a gradual deleveraging of the system by reining in credit growth and rebalancing the economy

Figure 14. Chinese Real GDP Growth and Credit



Sources: CEIC, People's Bank of China, Pivot Capital Management, Thomson Reuters Datastream, UBS, and Wind Information.

away from investment and more toward consumption. While needed over the long term, this rebalancing will likely continue to weigh on growth in the short term. Consumption simply cannot grow fast enough to offset a sharp fall in investment spending, which is the difficulty facing the new Chinese leadership—slowing the ship without sinking it. Though China's economy can rebalance over time, it's very unlikely to occur without some sort of accident. History shows that rapid debt accumulation (rather than the actual level) often presages some sort of crisis, such as Japan in the 1980s, emerging markets in the 1990s, or the United States in the 2000s. Thus, we feel there's potential for negative growth surprises going forward, although it is unclear in what form such an accident will occur, let alone the timing.[10]

Reform remains key to China's future. The 60-point reform plan released in November, while light on detail, was broad in scope and made clear the new leadership's desire for structural reform. Most notably, market forces are now to play a "decisive role" in the economy, mainly by forcing state-owned enterprises (SOEs) to compete with the private sector for access to land, credit, and other resources. While this falls short of the increased privatization of the SOE sector some analysts had hoped for, it is a clear departure from the previous administration, which sought to increase the role of the state in the economy. Fiscal reform is also slated to rein in local governments whose overinvestment alongside local SOEs has driven up debt levels, while at the same time the central government will increase social spending.

The reform plan touched on social, environmental, fiscal, and economic aspects, but made little mention of how it will deal with weakness in the financial system. That may follow the release of a comprehensive internal audit of local government debt due to be released by year-end 2013. A bold plan to deal with China's financial sector risks is needed and lifting this uncertainty will be a key market catalyst.

The reform plan shows a desire to rebalance the economy, but the lack of clear timetables or specifics highlights how gradual and tentative implementation will be. Risk of policy errors loom, although a too-rapid economic restructuring may be the bigger mistake.

Looking ahead to 2014, the authorities will likely continue to tighten credit following the modest relaxation this summer, with the PBOC already allowing interbank rates to gradually rise, while bond yields in China have risen to three-year highs. Such tightening will likely weigh on growth over 2014, although consensus forecasts are for a gradual slowing toward 7.5%. While such a modest slowing in growth alone would not be sufficient to trigger a financial crisis in China, the economy remains vulnerable to a sharper slowdown stemming from lagging external demand or a too-abrupt tightening of domestic credit. Fed tapering is unlikely to have a strong impact on China's financial system, given the closed capital account and current account surplus. However, both domestic and global tightening may weigh on growth more than the consensus expects.

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[10] Unlike emerging markets in the 1990s, China is not reliant on foreign capital flows, and unlike the United States in 2000s, Chinese consumers are not overleveraged. Rather, China faces a banking system over-exposed to domestic real estate collateral and loans to local government infrastructure projects and local SOEs. The situation is most similar to Japan in the 1980s, the consequences of which did not result in an immediate crisis, but rather a protracted slide into economic stagnation as the banking sector curtailed lending and companies deleveraged amid overcapacity.

With or without a hard landing, Chinese growth is undergoing a secular slowdown, with the recent reform agenda only confirming the move away from rapid investment-led growth. As a result, the tailwind of China's rapid demand for materials and infrastructure is fading and this realization is being priced in to markets. China's slowdown will certainly be a headwind for emerging markets, but its impact is also partly reflected in the price of China-sensitive sectors—especially energy and financial stocks, which trade below "pre-boom" valuation levels.

Summary: What's Ahead for Emerging Markets?

What does this year's wide divergence between EM and DM equities and the divergence among EM equities mean for investors?

Today, we still see a valuation case for emerging markets, based on a belief that over the long term, valuations should normalize and EM equities do not deserve a discount quite as large as at present. Still, this undervaluation is concentrated in the sectors with the strongest headwinds, while the consumer theme seems fully priced. Indeed, financial and energy/materials stocks seemingly hold the key to broad EM index outperformance.

In the near term, EM equities may be poised for a burst of outperformance after lagging so much in 2013. Cheap China-sensitive sectors and markets would likely drive such a rally, especially if U.S. and European demand picks up and Chinese growth surprises to the upside, or investors take a more constructive view on Chinese banks.

In the intermediate term, EM equities face several headwinds that may cap future outperformance, especially relative to the previous cycle. EM equities performed phenomenally well over the previous cycle—the return differential over 2003–07 was astounding as EM equities returned 391% versus "only" 119% for the MSCI World Index. Much of this outperformance, however, was due to extremely depressed absolute and relative valuations for EM equities in 2001–02, with emerging markets trading at 50% discount to DM equities, and nearly every sector and country cheap. Today's valuations are not as extreme and undervaluation not so widespread (including EM currencies), thus outperformance going forward will not be as strong. Further, much of the previous run-up was tied to China's integration into the global economy following its ascension to the WTO in 2001, which helped shape today's global supply chains and triggered the commodity boom. The strong performance in this period also drove widespread adoption of EM equity allocations within institutional portfolios.[11]

These tailwinds, which drove a broad-based rally across all emerging markets in this earlier period, no longer exist. Indeed, the divergence we have seen in 2013 could intensify if Fed tapering occurs and puts markets and currencies with weak current account fundamentals under pressure. For instance, in November Chinese equities rallied 5% while the broader EM index was flat, despite China's near 20% weight in the index, as other markets pulled back on tapering fears. At the same time, if the United States and other developed economies accelerate while China slows more than the 7.5% consensus expectation, the gap between China-sensitive sectors and consumer sectors could widen. Such an environment would require a more nuanced approach to EM

[11] EM equity market capitalization has risen from 4% of the MSCI All Country World Index in 2002 to 14% in 2010 and down to 11% in 2013.

equities. Active managers generally lagged in the last cycle; going forward, country/sector dispersion should benefit active managers. The beaten up China-plays look attractive and overdue a rebound in the near term, but the leaders of a previous market cycle (China plays) are rarely the leaders of the next cycle. Thus managers able to rotate across country and sector themes should be able to add value. Managers that have done well in 2013 were those willing to rotate into depressed cyclicals in early summer.

Still, good things happen to cheap stocks. Given current relative valuations, especially versus U.S. equities, modest overweight positions in EM equities are warranted. If and when relative valuations normalize, investors should seek to reduce EM equity exposure to neutral. Until EM equities again offer crisis-like valuations, investors should not seek to implement large overweights.

Investment Advice

☞ **What's a value investor to do? Cambridge Associates' advice from our Chief Investment Strategist.**

Celia Dallas

As we look ahead to 2014, our broad advice is much the same as it was in June. Quoting our mid-year outlook, *Positioning for an Eventual Return to Temperance*:

> Investors should remember that the market action seen today is associated with a punch-bowl that central banks are refilling with roughly $7 billion of liquid refreshment every trading day. At some point, they will begin to pour more slowly. If portfolios are not suited to weather a less-stimulative environment, now is the time to change that.

Even as unemployment in the United States has shown some improvement in recent months, it remains at high levels with a still-low labor participation rate. In much of Europe, the situation is worse, although it appears to have at least stabilized. With inflation showing no sign of life, central banks clearly have leeway to remain easy for a long time even should the U.S. Fed cut back on quantitative easing. And the Bank of Japan seems more likely to further prime the pump than to cut back the flow of liquidity as it seeks to break Japan of its deflationary mindset. With timing of any increase in rates unknown, investors should review their portfolios to understand what they own and consider how diversified the portfolio truly is. What is vulnerable to an increase in interest rates? What if rates don't rise, but the economy experiences a setback—certainly a possibility given the generally low-growth global environment—is the portfolio adequately diversified?

Our checklist of important investment considerations for 2014 is as follows:

Review the portfolio to make sure it is not too heavily exposed to assets that would be vulnerable to a rise in interest rates, especially if such assets are intended to a play relatively defensive role in the portfolio. The combination of interest rate sensitivity, dependence on interest rates to generate returns (e.g., ability to capture other return drivers such as economic growth, credit risk, and other factors), and current valuations will provide a reasonable guide. In fact, some of the assets most vulnerable to a diminution in liquidity and a rise in rates are also most expensive, as investors grabbed for yield in higher-risk income-paying assets, seeking replacements for paltry cash and sovereign bond yields. Despite the increase in yields, we suspect that over-valued bonds, including investment-grade and high-yield credits; REITs; utility-heavy, low-volatility "defensive equity" funds; and some high-dividend-yield equities remain vulnerable. U.S. high-quality equities (defined as equities with low leverage and stable profitability and earnings) were not as bid up, and still offer appeal from a long-term perspective.

Be careful in credits. While credit valuations have improved amid the recent back up in yields, we find limited value in broad fixed income markets today. Base sovereign yields remain skimpy, rendering prospects even for credits with reasonable spreads uninspiring. Although credit fundamentals are not generally worrisome, signs that the credit market is becoming more extended are developing. In recent months, we have seen an increase in more aggressive transactions to fund acquisitions/buyouts. Should this continue, credit quality will eventually suffer, although default rates remain low today. Still, low yields mean many assets with a fixed coupon are likely to provide subpar returns over the medium and long term.

Perhaps of more concern to investors that view credits as safe assets is the diminished liquidity in fixed income markets as banks have been less willing to hold bonds on their balance sheets in the post-2008 era of tighter bank regulations. This applies to all fixed income, including the deep and liquid U.S. Treasury market, but appears to be most acute for credits, EM debt, and inflation-linked bonds. Liquidity takes several forms, but we would note in particular that bid/ask spreads have been wide relative to pre-2008 norms since dealers have stepped back from making markets in fixed income. We would expect liquidity conditions to worsen should rates rise either through increased credit spreads or base rates. Investors in solid credits that can buy and hold should be fine, but investors that may need to sell such bonds in the near term (or that invest in vehicles in which the manager might need to sell to fund redemptions, for example) should consider if their assets would be better positioned in more liquid assets and should be prepared to ride out mark-to-market volatility.

In general, we prefer diversifying exposures such as U.S. high-quality equities, other sorts of defensive equities, long/short hedge funds, and certain other lower-equity beta, less-credit-dependent hedge fund strategies to credits today.

Put U.S. equities on a valuation watch list. Among growth-oriented assets, U.S. equities are the most expensive region and remain vulnerable to disappointment. As noted earlier, we don't think U.S. equities are in a bubble, but they are expensive. Long-term return expectations from a starting point of today should be tempered.

That is not to say that U.S. equities can't go up from here—in fact, this may be the path of least resistance, particularly if liquidity conditions remain supportive. While the market has been on quite a tear since it bottomed in March 2009, such rebounds are not without precedent. Yes, this rally is getting long in the tooth, and the magnitude is on the high side from a historical perspective, but there is certainly scope for the bull run to go further. The magnitude and duration of the current rally is virtually unprecedented in cyclical bulls during secular bears, but looks more commonplace compared to secular bull markets (Figure 15). Only five of 16 bull runs during secular bears could be considered comparable, with gains of more than 100%, while half of bull runs during

Figure 15. Magnitude and Duration of S&P 500 Cyclical Bull Markets

Low Date	High Date	% Gain	Real % Gain	# Days
Cyclical Bull Market Rallies Amid Secular Bear Markets				
11/13/1929	04/10/1930	46.8	50.2	148
12/16/1930	02/24/1931	25.8	29.0	70
06/02/1931	06/27/1931	27.1	28.7	25
10/05/1931	11/09/1931	30.6	31.5	35
06/01/1932	09/07/1932	111.6	114.7	98
02/27/1933	07/18/1933	120.6	113.9	141
10/21/1933	02/06/1934	37.9	37.9	108
03/14/1935	03/06/1937	131.8	125.2	723
03/31/1938	11/09/1938	62.2	63.4	223
04/08/1939	10/25/1939	29.8	28.8	200
06/10/1940	11/09/1940	26.8	26.8	152
10/07/1966	11/29/1968	48.1	36.8	784
05/26/1970	01/11/1973	73.5	57.6	961
10/03/1974	11/28/1980	125.6	33.5	2,248
09/21/2001	01/04/2002	21.4	22.5	105
10/09/2002	10/09/2007	101.5	74.6	1,826
	Average in Secular Bears	**63.8**	**54.7**	**490**
Cyclical Bull Market Rallies Amid Secular Bull Markets				
02/20/1928	09/07/1929	88.3	86.1	565
04/28/1942	05/29/1946	157.7	124.3	1,492
05/17/1947	06/15/1948	24.4	13.1	395
06/13/1949	08/02/1956	267.1	218.9	2,607
10/22/1957	12/12/1961	86.4	75.8	1,512
06/26/1962	02/09/1966	79.8	70.7	1,324
08/12/1982	08/25/1987	228.8	180.2	1,839
12/04/1987	03/24/2000	582.2	359.8	4,494
	Average in Secular Bulls	**189.3**	**141.1**	**1,779**
	Average of All Cyclical Bull Rallies	**108.4**	**86.3**	**916**
Current Period*				
03/09/2009	11/30/2013	167.1	142.7	1,727

Sources: Ned Davis Research, Inc., Standard & Poor's, and U.S. Department of Labor - Bureau of Labor Statistics.
Note: Cyclical bull markets are defined as rallies of at least 20% in nominal terms without a decline of 20% or greater.
* Represents the gain in the most recent rally; does not imply the market has reached a final high.

secular bull markets have seen gains of more than 150%.

Nonetheless, as the adage goes, no one rings a bell at the top, and valuations are becoming stretched on peak profit margins. Top-line growth is required to improve earnings from here—not impossible, but clearly more challenging. We currently recommend investors underweight U.S. equities relative to European equities and EM equities within a neutral weight to equities as a whole in portfolios. However, given the sharp rise in U.S. equities, and their tendency to become vulnerable when valuations become very overvalued (at least 1.5 standard deviations above fair value), we would monitor their ascent and prepare to decrease allocations further should valuations reach such heights. As of the end of November, that translates to a 13% increase in U.S. equities without a concurrent increase in normalized earnings. We would put the proceeds to work in whatever growth-oriented assets offer the best relative value at the time. Today, non-U.S. developed markets (based on the MSCI EAFE ex Japan Index) trade nearly 2 standard deviations below their historical average discount to U.S. equities. While such equities would also be vulnerable should the U.S. market suffer a setback, the relatively cheap valuation may be adequate to provide some downside protection. More importantly, the lower valuation stacks the odds of better long-term performance.

Monitor Japanese equities for cheapness and watch for progress on structural reform. We have remained neutral on Japanese equities, foregoing any benefit from overweighting the strongest performing major equity market in 2013 (at least in local currency terms).[12] While valuations in Japan are undemanding, they are not markedly cheap. Investors are digesting the impact of recent stimulus measures on the economy and whether the Abe administration can push through economic reforms. Japanese equities remain vulnerable to disappointing earnings, especially as the benefit of the yen's weakness seems to have been priced in. Further, some questions (including those about the country's gargantuan debt burden and whether the recent improvement in earnings is sustainable absent additional dramatic moves in the yen) loom large, and valuations are not compelling given these and other risks.

While the Japanese economy and stock market may indeed both be on a path to improved performance, we prefer to wait and see if meaningful economic reforms come to pass. Should we see signs of such progress along with inexpensive equities relative to the improved outlook, we would become more constructive. We would also be more positive on Japanese equities should the market suffer a near-term setback that brings it to cheap levels.

Monitor deflation-hedging and inflation-sensitive allocations. We would be sure to have adequate exposure to defensive assets today, but would be mindful of valuations. We continue to recommend investors hold a minimum degree of protection against the risks associated with unexpected inflation and economic contraction—just enough to cover relatively near-term spending and liquidity needs (i.e., roughly two years, depending on individual investor circumstances). Implementation should take into account both the objective for such protec-

[12] We remain supportive of global managers with Japan overweights based on stock-specific views. We also note that if the decline in the yen moderates, other sectors may begin to lead the next leg of the market rally, while any emergence of a domestic mergers & acquisitions market (long the dream of foreign investors) is likely to benefit small- to mid-cap stocks.

tion and its somewhat lofty prices. Should intermediate- to long-term rates rise further, valuations for deflation-hedging allocations (high-quality sovereign bonds) would become more attractive. For the last few years, we have recommended holding cash as part of such allocations as high-quality sovereign bonds remain overvalued, and more recently have been recommending moving back from cash into bonds as yields have increased. Should yields approach our fair value range, we would recommend moving fully back into sovereign bonds, keeping in mind that yields can move rapidly in the current environment. For example, U.S. ten-year Treasuries are not far from the low end of our fair value range of 3.0%, so it may now be a good time to set up a process to move into such bonds if yields were to rise to such levels. In contrast to high-quality sovereign bonds, U.S. municipal bonds are fairly valued. We believe a neutral allocation to muni bonds is warranted.

With regard to inflation-sensitive assets, implementation has also been difficult as such assets have remained expensive and commodities have had other implementation hurdles. Valuations of inflation-linked bonds and commodities have improved, while the impact of contango's drag on commodity returns has lessened. We continue to favor natural resources equities and leveraged loans to more inflation-sensitive assets, but should valuations continue to improve, we would rotate back into commodities and inflation-linked bonds, which should have more sensitivity to inflation and less equity and credit risk than our current implementation recommendation. We are watching credit conditions and would pare back leveraged loan allocations if fundamentals were to show signs of weakening.

Should policy rates rise, gold would likely remain vulnerable, as it has been each time there has been even a slight hint that central banks might withdraw some support. While impossible to tell if current pricing, down nearly 30% from year-ago levels, adequately handicaps the chance of tapering, gold is clearly less expensive today even as the risk to the U.S. dollar remains elevated, with the U.S. Fed's balance sheet approaching $4 trillion. As such, we think most investors should hold a small allocation to gold. The expensive valuations of other assets, such as commodities in general, that serve as macro hedges for which gold can be used as a substitute (and from which the gold position should be funded) and the current low/negative real interest rate environment reinforce our view. We recommend taking a position given the likely high "payoff " if the risk gold is intended to hedge against ensues, but would make the position small (and tied to an investor's spending needs and risk tolerance) because of the inability to value gold—which means the downside risk is potentially large.

Conclusion

Overall, we see some relative value in the markets, but valuations have been bid up across the risk/return spectrum. European and EM equities, particularly cyclicals in these markets, offer compelling relative value. That is about the best a value investor can do today—the world is all relative. At the same time, the liquidity tide that lifted all ships will recede at some point. Investors should prepare for this eventuality, taking advantage of opportunities that will surely arise in its wake while not letting down their guard should our persistent worry of deflation remain the more virulent risk ahead. Indeed, headline CPI has been falling in developed markets since late 2011 and has fallen below 1% in the United States and the Eurozone. ■