Market Matters

January 31, 2014

Equity markets sold off in January as investors fretted over emerging markets growth and digested 2013's performance; safe-haven assets such as U.S. Treasuries and gold fared better and recouped some of their recent losses

Major global equity markets began the year on a decidedly downbeat note, posting their first across-the-board January declines since 2010. A number of factors weighed on sentiment including concerns over the impact of tapering by the Federal Reserve, rising indebtedness/slowing Chinese growth, and balance of payment crises in certain emerging markets countries. Against this backdrop micro drivers of markets such as valuations and earnings growth took a backseat, though stretched valuations for U.S. equities and declining earnings forecasts in some emerging markets have not been helpful. Perceived "safe haven" assets such as U.S. Treasuries (1.4%) and gold (2.9%) fared well in January given rising risk aversion, with the performance of the former wrong-footing many who assumed that Treasury yields were a one-way bet given reduced Fed purchases and stronger growth.

U.S. equities (-3.4%) slightly underperformed developed markets as a whole (-3.2%), despite generally improving macro data. A strong second half meant GDP expanded by 1.9% in 2013, as drivers of growth such as consumption and housing continue to improve; the Case-Shiller House Price Index recorded a 13.8% year-over-year rise in November, the fastest since 2006.

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For our views on specific asset classes, read **Asset Class Views**

All returns are total returns in local currency unless otherwise noted.

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Not all U.S. macro data has beaten expectations, though certain statistics such as December's disappointing new-home sales and non-farm payroll number (showing that just 74,000 jobs were created during the month) may have been distorted by extremely cold weather. Earnings reports for U.S. companies have generally been strong. Of the 251 S&P 500 companies that have reported fourth quarter earnings, 74% have beaten estimates. Less encouraging is that many companies are guiding analysts to lower earnings forecasts for 2014, citing factors such as the rising U.S. dollar (which lowers the value of offshore profits) as well as slowing emerging markets growth.

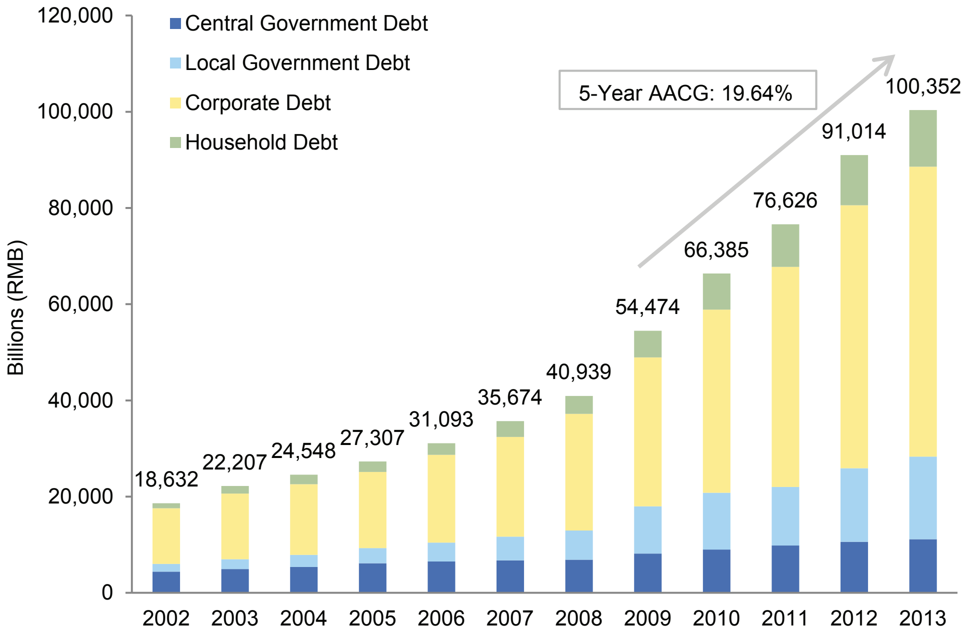
After a tremendous run in 2013, Japanese stocks (-6.7%) heavily under-performed in January. Earnings news has generally been positive; 63% of TOPIX-listed companies reporting thus far in 2014 have beaten estimates and many analysts have boosted 2014 forecasts. However, concerns are mounting over a reversal in the macro-driven tailwinds from 2013. April's anticipated increase in the consumption (VAT) tax to 8% is expected to weigh on consumption, and the one-off hike in government spending last year that helped boost GDP growth may not be repeated given deficit concerns, creating a fiscal drag. Many strategists remain tactically bullish on Japan given the potential for domestic investors to boost allocations to equities, but it is worth remembering that Japanese investors would actually have fared better in 2013 investing unhedged in U.S. equities (!) despite the massive 54.6% return for the MSCI Japan Index because of the depreciation in the yen versus the U.S. dollar.

Across the sea from Japan, Chinese equities (-6.6%) also fared poorly. Worries persist about the pace and quality of Chinese GDP growth despite 2013's reported growth rate of around 7.7% matching 2012's. Pessimists point to weakness in some of the recent economic data (such as the December HSBC flash manufacturing PMI estimate) that show contraction; stronger data (like the official PMI data) have been largely ignored by investors. The near default of an investment vehicle created by one of China's numerous investment trusts drew scrutiny in January, setting off alarms about possible contagion and impacts on the wider economy. China weighed down the broader emerging markets equity index (-4.4%), as did ongoing concerns about countries with twin deficits (current account and fiscal) and their vulnerability to Fed tapering and investor outflows. More vulnerable countries were thrashed by investors, with Brazilian (-8.2%) and Turkish (-8.7%) stocks seeing the biggest sell-offs. While a number of emerging markets central banks hiked interest rates during the month to try to shore up currencies and discourage outflows, equity investors are increasingly fearful about the impact this will have on growth and thus corporate profits. Rate hikes and currency depreciation triggered losses for local currency–denominated emerging markets debt investors; the main index returned -4.6%, adding to its -9.0% return for 2013. US$-denominated sovereign and corporate debt fared much better as U.S. Treasury yields declined.

European markets were far quieter given generally improving macro conditions and more favorable equity valuations. The MSCI Europe Index returned -2.2%, with continental markets outperforming U.K. equities. Though Eurozone economic data is only slowly improving, sentiment about the periphery is soaring; Irish and Spanish ten-year government bond deals in January drew massive investor demand. U.K. economic data generally surprised to the upside (2013 GDP growth of 1.9% should match U.S. levels and is the best since 2007), but the U.K. index can be more heavily influenced by perceptions about global economic activity. In January management at several consumer staples firms warned about slowing sales (the sector returned -7.0%); the energy sector (-5.4%) also struggled given disappointed earnings results. ■

Distribution of Chinese Debt

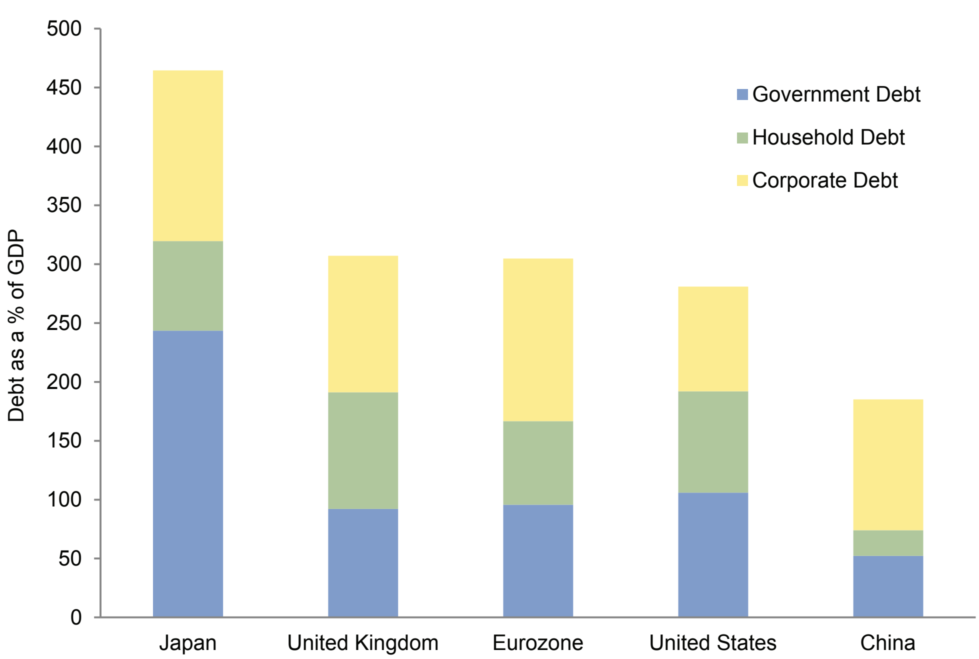
2002–13



Sources: BofA Merrill Lynch, CEIC, and NBS.
Note: Data for 2013 are through June 30.

Chinese debt levels have grown faster than GDP in recent years, raising concerns over China's development model and a potential nonperforming loan problem

Debt as a Percentage of GDP

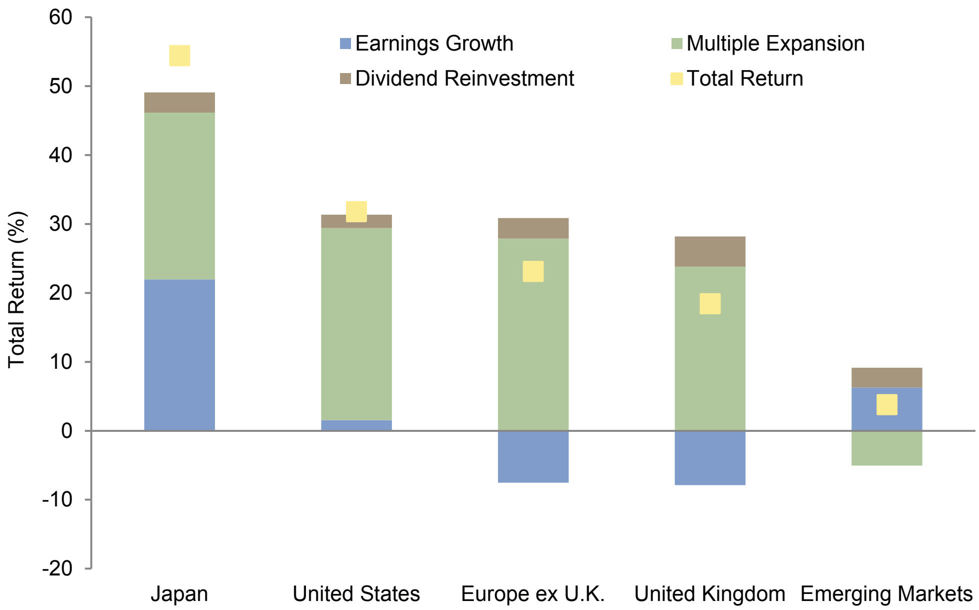


Sources: BofA Merrill Lynch, International Monetary Fund, and Thomson Reuters Datastream.
See last page for notes.

China's debt/GDP ratio has risen, but remains well below levels seen in developed markets

Equity Returns by Source

As of December 31, 2013



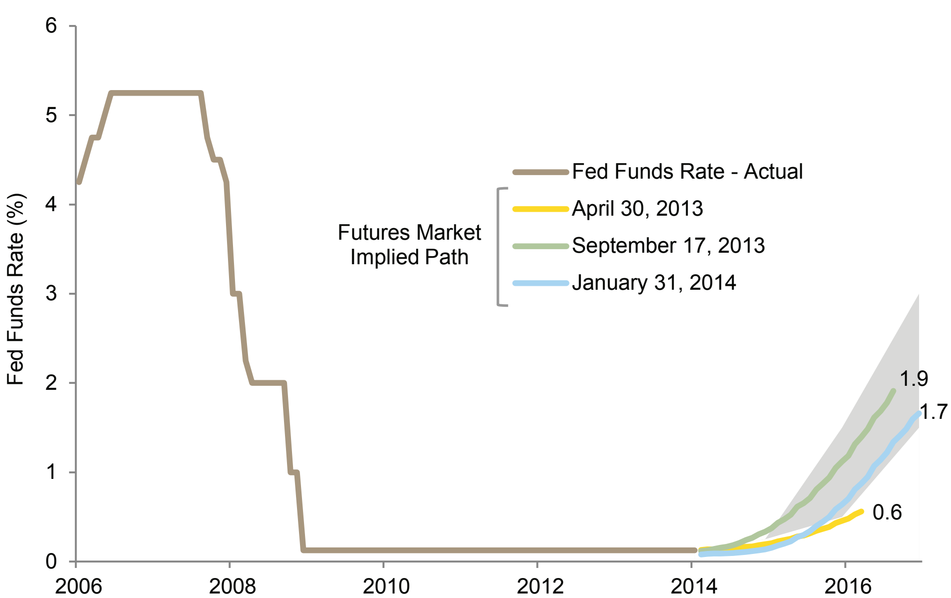
Sources: MSCI Inc., Thomson Reuters Datastream, and Tokyo Stock Exchange. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Multiple expansion drove most equity returns in 2013; in 2014 companies may need to deliver on earnings expectations for the rally to continue

Fed Funds Rate and Implied Path

January 31, 2006 – January 31, 2014



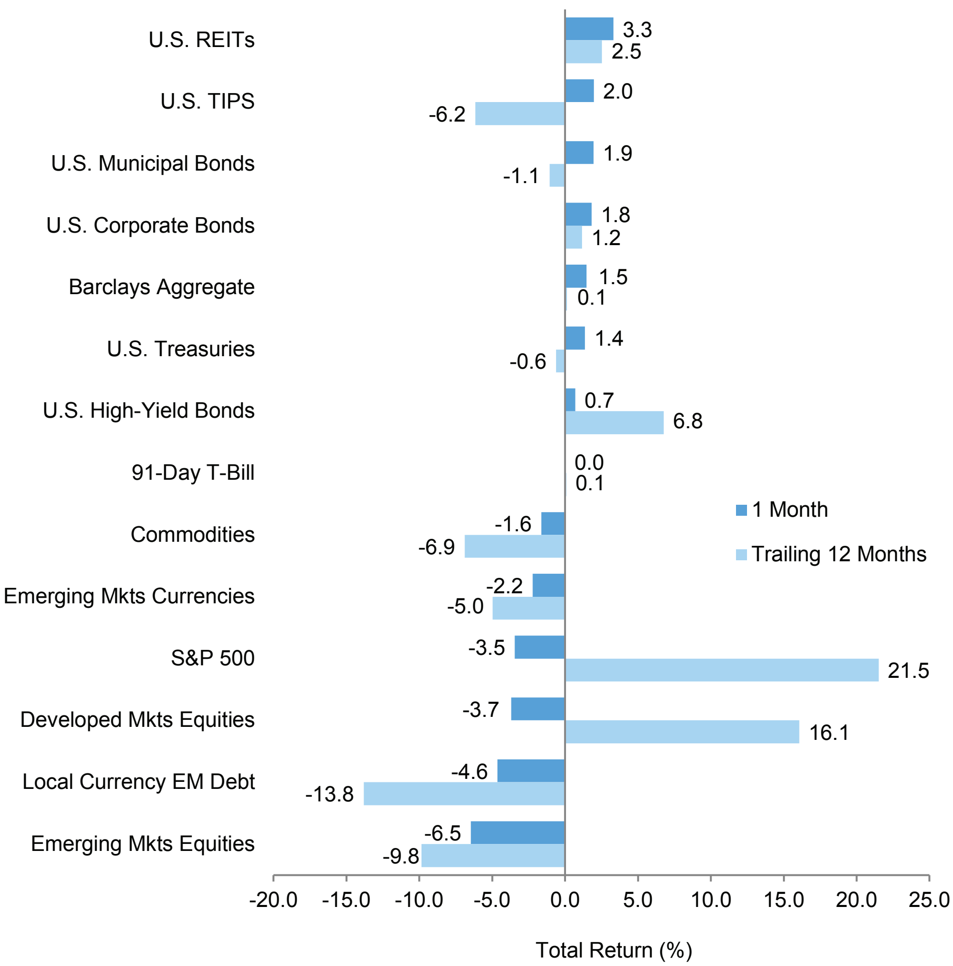
Sources: Bloomberg L.P., Federal Reserve, Thomson Reuters Datastream, and U.S. Department of Labor - Bureau of Labor Statistics.

Note: Shaded area represents the range of forecasts from FOMC members as of the December 18, 2013 meeting.

The Fed has begun tapering, but short-term rates should stay low for an extended period

Index Performance (US$)

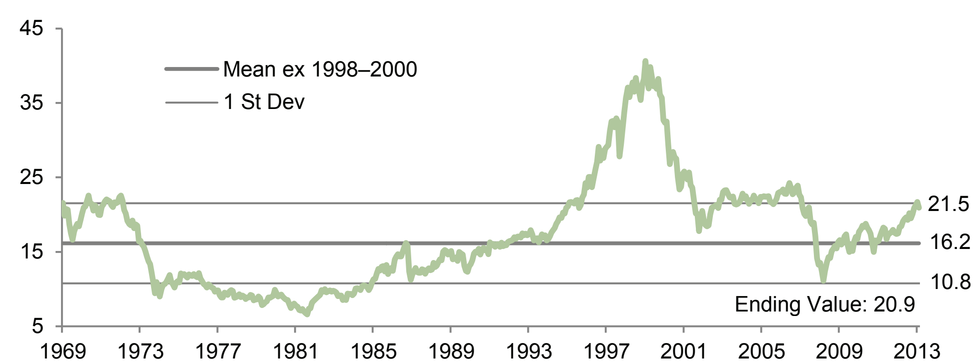
As of January 31, 2014



U.S. equities slightly outperformed developed markets peers (in US$ terms) as the U.S. dollar strengthened given a flight to quality; safe haven assets such as U.S. Treasuries and gold rallied

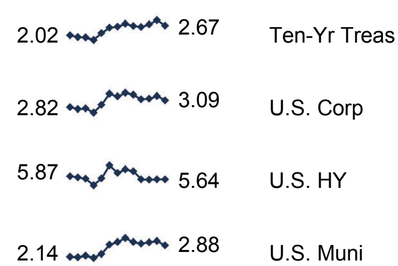
MSCI U.S. Composite Normalized P/E

December 31, 1969 – January 31, 2014



Fixed Income Yields

Jan 2013 – Jan 2014

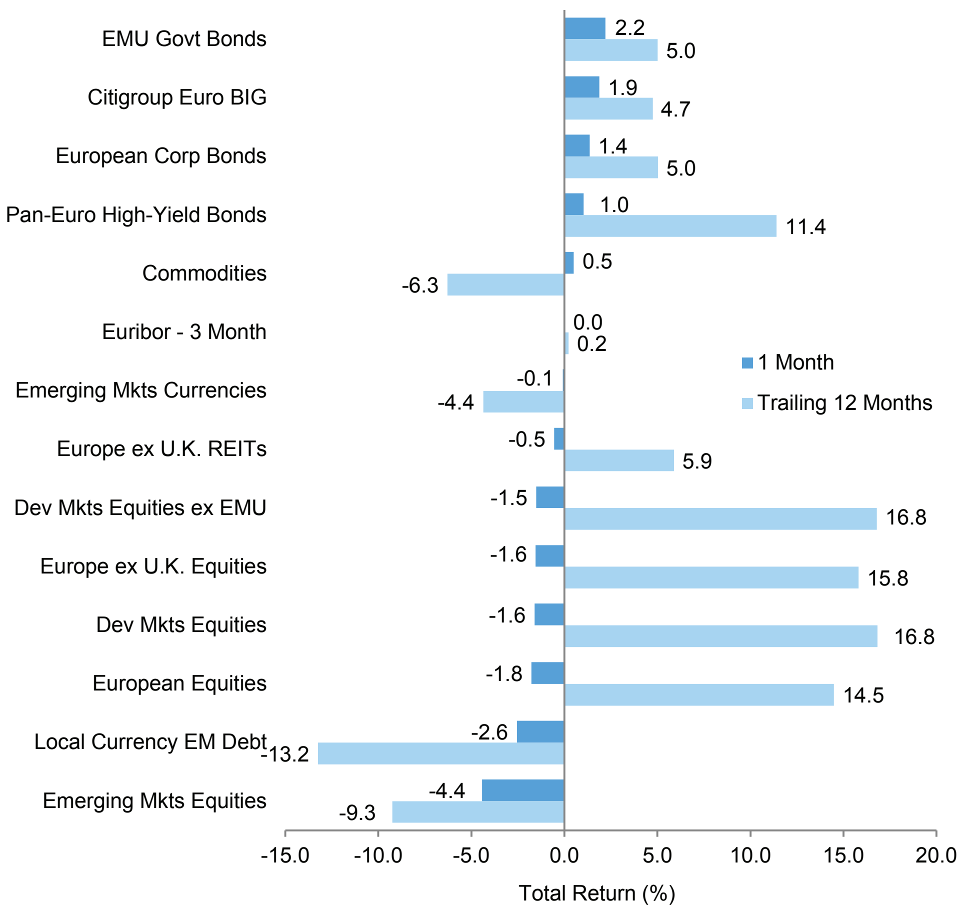


Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Index Performance (€)

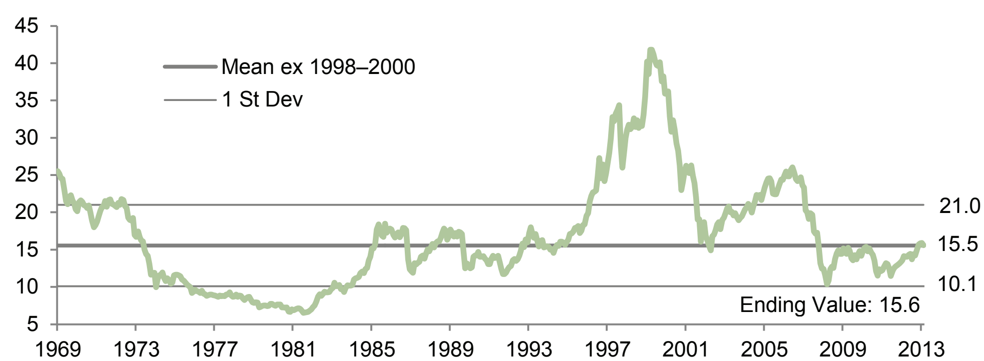
As of January 31, 2014



European stocks underperformed developed world peers (in € terms), but valuations remain favorable and macro data continue to improve; declining interest rates generated strong returns for government bonds and higher-duration credit

MSCI Europe ex U.K. Composite Normalized P/E

December 31, 1969 – January 31, 2014



Fixed Income Yields

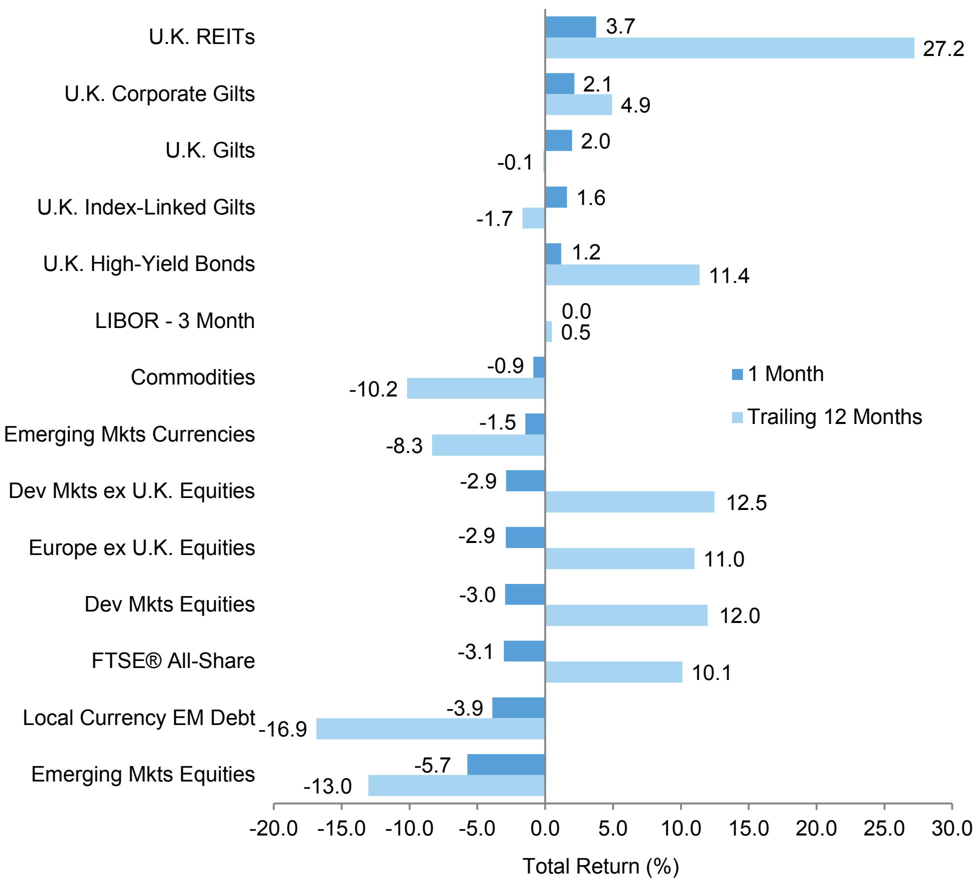
Jan 2013 – Jan 2014

Sources: Barclays, Citigroup Global Markets, EPRA, 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.

See last page for notes.

Index Performance (£)

As of January 31, 2014



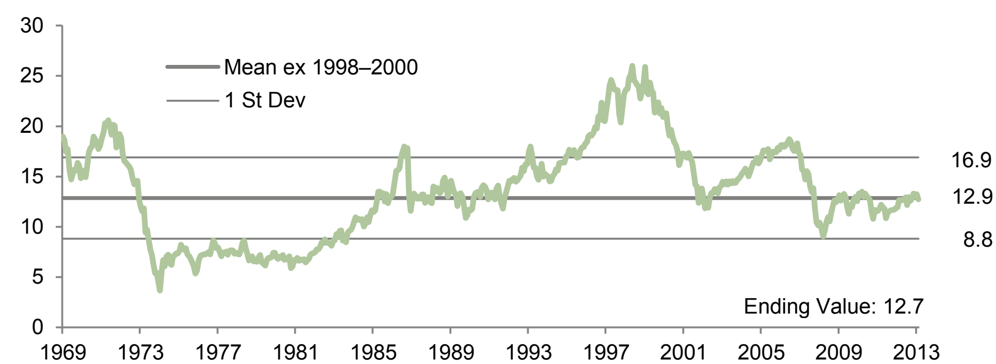
U.K. stocks slightly underperformed developed markets peers despite improving macro data as earnings results were mixed; gilts and sterling corporate bonds generated strong returns as yields compressed

Fixed Income Yields

Jan 2013 – Jan 2014

MSCI U.K. Composite Normalized P/E

December 31, 1969 – January 31, 2014



Sources: Barclays, BofA Merrill Lynch, EPRA, 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.

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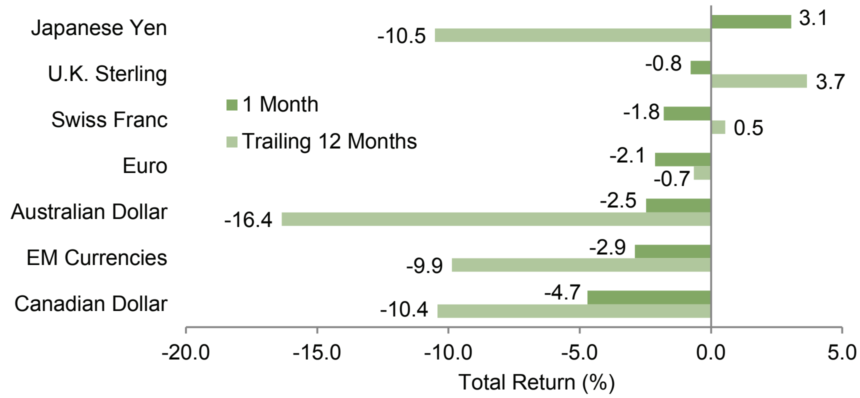
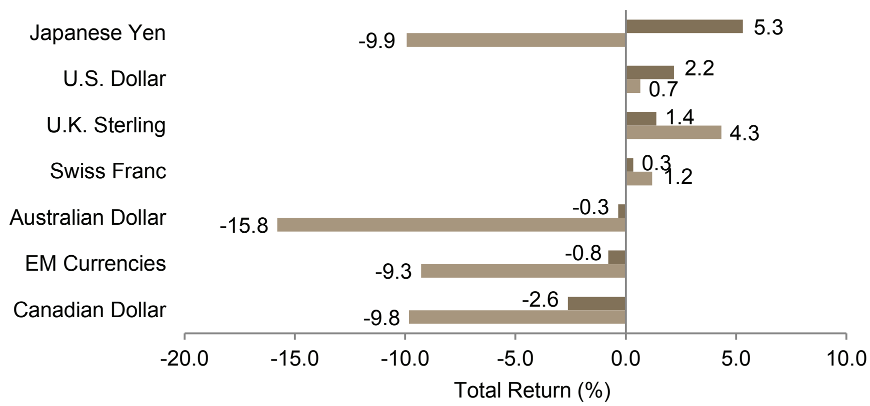
Currency Performance

As of January 31, 2014

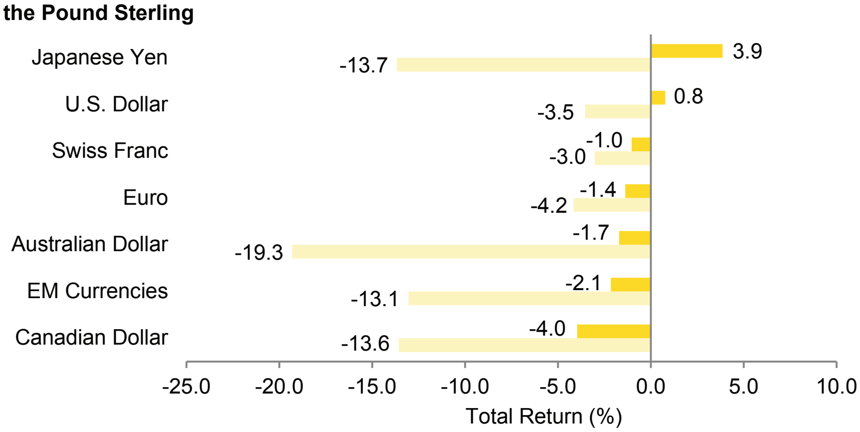
Versus the U.S. Dollar



Versus the Euro



Versus the Pound Sterling



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: EM Currencies is an equal-weighted basket of 20 currencies.

The yen rebounded in January but is still significantly lower over the past year; emerging markets currencies continue to suffer given balance of payment concerns despite rate hikes in many countries

Exhibit Notes

Debt as a Percentage of GDP Exhibit
Corporate debt excludes financial corporations. All data for China as of June 30, 2013. For remaining countries, data on household and corporate debt as of December 31, 2012, and government debt data as of December 31, 2013.

Equity Returns by Source Exhibit
All returns are in local currency terms. Multiple expansion is represented by the change in the price-earnings (P/E) ratio. Earnings growth is based on aggregate 12-month trailing earnings. Dividend reinvestment is the 12-month total return minus the 12-month price return. All three components of return geometrically compound to total return.

Performance Exhibits
Total returns for MSCI developed markets indices are net of dividend taxes. Total returns for MSCI emerging markets indices are gross of dividend taxes.

U.S. dollar index performance chart includes performance for the Barclays Aggregate Bond, Barclays Corporate Investment Grade, Barclays High Yield Bond, Barclays Long Govt Bond, Barclays Municipal Bond, Barclays U.S. TIPS, BofA Merrill Lynch 91-Day Treasury Bills, FTSE® NAREIT All Equity REITs, J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI World, S&P 500, and S&P GSCI™ indices.

Euro index performance chart includes performance for the Barclays Euro-Aggregate: Corporate, Barclays Pan-Euro High Yield, Citigroup EMU Govt Bonds, Citigroup Euro BIG, FTSE® EPRA/NAREIT Europe ex U.K., J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI Europe, MSCI Europe ex U.K., MSCI World ex EMU, MSCI World, and S&P GSCI™ indices as well as Euribor.

U.K. sterling index performance chart includes performance for the Barclays Sterling Agg Corps, BofA Merrill Lynch Sterling High Yield, FTSE® British Government All Stocks, FTSE® British Government Index-Linked All Stocks, FTSE® All-Share, FTSE® EPRA/NAREIT U.K., J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI Europe ex U.K., MSCI World, MSCI World ex U.K., and S&P GSCI™ indices as well as Libor.

Valuation Exhibits
The composite normalized 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.