Market Matters

July 31, 2014

Emerging markets equities continued their recent run of strong performance as earnings and macro data improved while developed markets stocks struggled given richer valuations and tensions with Russia; as some sovereign yields reached historical lows, European bonds continued to generate healthy returns.

Equity markets were mainly unchanged in July as generally positive earnings and macro releases served to offset rising tensions over Ukraine and another Argentine sovereign bond default. Putting aside geopolitical wobbles, July's developments illustrated the year's main themes. Macro data continue to steadily improve across most regions, albeit unevenly. Meanwhile, dovish central banks continue to provide a floor under many asset prices, though inflation is not entirely being held at bay. Where earnings growth has been strongest, this was largely anticipated by equity valuations. And, as the last few days of July demonstrate, thin trading volumes provide fertile ground for volatility to increase from historically low levels.

A 2% decline on the final day of the month dragged down the return on US equities (-1.4%) despite relatively strong earnings reports. Around 75% of S&P 500 companies reporting thus far have met or exceeded earnings expectations; average earnings per share (EPS) growth has been around 10%, with strength seen across a broad spectrum of sectors including health care and IT. Stretched valuations mean that small caps continue to underperform

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

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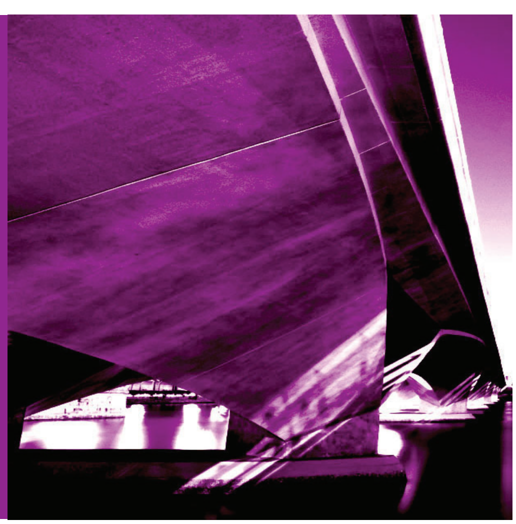
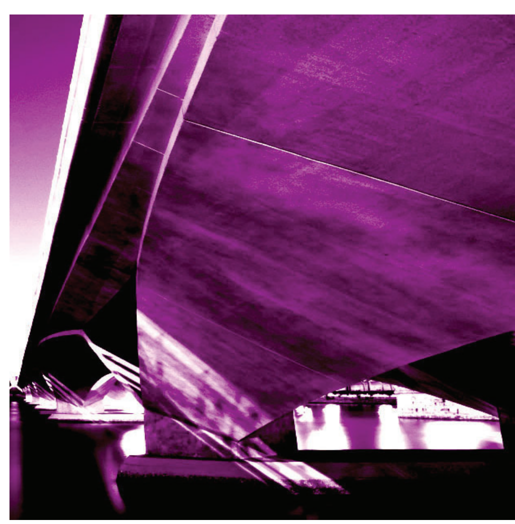




large caps; in July the Russell 1000® Index trounced the Russell 2000® by over 440 bps. US macro releases were strong; the initial estimate for second quarter GDP growth came in at 4% on an annualized basis and the weak first quarter number was revised slightly higher. The flipside of rising growth and price data (June CPI again exceeded 2% year-over-year) was that bonds struggled; the yield on the ten-year US Treasury rose slightly to 2.58%. Federal Reserve Chair Janet Yellen did her best to keep yields in check by making dovish comments about softness in the labor market and a possible link to low wage inflation. In a separate speech she echoed the view of many market observers (including ourselves) that higher beta credit was overvalued. Investors seemed to take notice; outflows accelerated and US high-yield bonds (-1.3%) sold off.

European equities (-1.8%) also were in the red despite relatively positive earnings announcements. Nearly 60% of companies reporting thus far have beaten expectations and 20% earnings growth has been higher than that seen in the United States. Toward month end, some consumer staples and discretionary firms disappointed, in some cases blaming weaker emerging markets sales and the strong euro. Against the backdrop of new Russia sanctions, a handful of firms suffered outsized sell-offs. Most valuation metrics support European stocks (e.g., our composite normalized price-earnings [P/E] ratio of 14.6), but earnings weakness means the trailing P/E of 17.2 is now 19% above its historical average. Relief may come from the weaker euro, which now trades at one of the lowest levels against the US dollar since last November. The European Central Bank is fully on board with a cheaper currency and June's CPI print (0.5%, similar to 2009 levels) suggests it has room to do more. Slow growth and subdued inflation mean many Eurozone yields continue to set historical lows, generating outsized gains for assets such as Eurozone sovereign bonds (7.6% year-to-date). German ten-year bunds yielding 1.17% or Spanish sovereign bonds at 200-year lows seem, at least to us, a recipe for very disappointing subsequent returns.

UK economic data have been more robust and July's releases were no exception. UK GDP grew at over 3% on an annualized basis in the second quarter and unemployment continues to decline more rapidly than expected. Still, the economy has only now recovered the ground lost since the recession, reflecting the scale of the damage. UK stocks (-0.3%) outperformed but lag Eurozone peers year-to-date; UK valuations look better on a relative basis but expected earnings growth is weaker. Sterling fixed income again posted gains despite the growth data and inflation, which hovers near 2%. Like US Treasuries, gilts offer relative value compared to Eurozone sovereigns; the

Bank of England also is doing its best to dampen expectations of rate hikes. Gilts returned 1.0%, bringing their year to-date total to 4.6%.

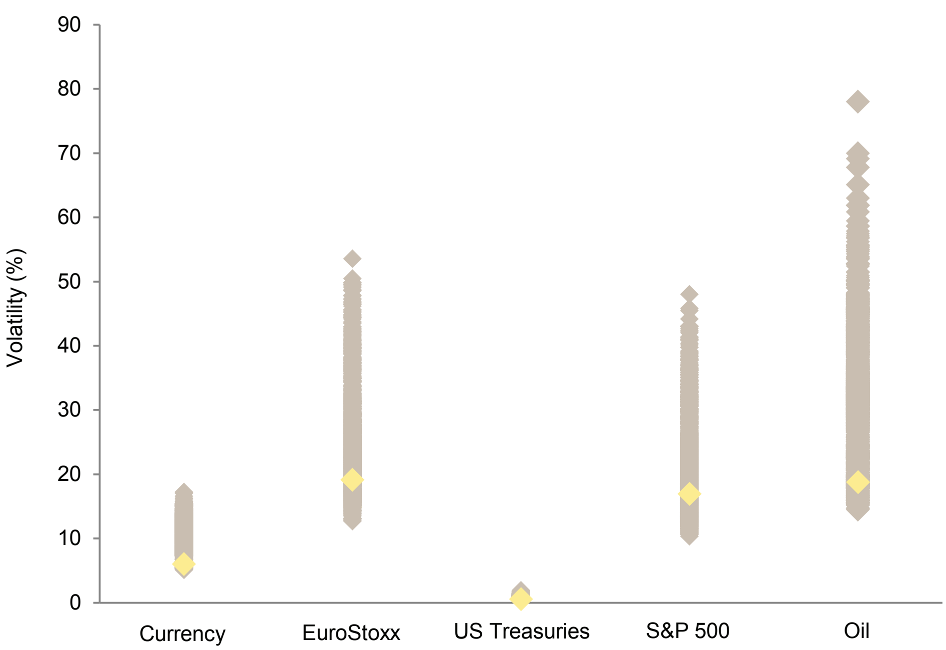
Japanese equities (2.1%) recouped some of their year-to-date under-performance despite earnings reports that showed EPS shrank around 45% year-over-year; 2013 provides a tough benchmark given the yen sell-off dramatically boosted earnings. Japanese equities have been supported by optimism about potential purchases by the main government employee pension fund as well as hope that the Bank of Japan (BOJ) will stimulate further. Recent economic weakness suggests it may need to do something; in July the BOJ cut its growth forecast for fiscal year 2014 (to 1%) and inflation readings—a key goal of Abenomics—continued to fade.

July saw emerging markets equities (3.1%) continue their recent strong run, outperforming developed markets peers by nearly 400 bps. Valuations are supportive on both a normalized and short-term basis. For example, the MSCI Emerging Market Index trades at around 12 times 2014 earnings, roughly a 30% discount to the United States, and some markets are even cheaper. Expectations are high for 2014 EPS as growth is expected to rebound both domestically and in key export markets. News that Chinese GDP grew at a 7.5% pace in the second quarter supported local equities, helped by easing and credit spigots being turned back on. Some analysts estimate that Chinese total debt/GDP may have risen by as much as 17 percentage points during the last six months, possibly sowing the seeds for future problems. However, political developments elsewhere in emerging markets like the recent Indian elections also have put the wind back into emerging markets sails.

Finally, real assets cooled in July after their blistering start to the year. Commodities (-5.3%) were buffeted by a variety of forces. Oil fell sharply as concerns eased over key exporters like Iraq and Libya curbing production and also as US domestic production approaches its highest level in three decades; agriculture sold off heavily as key crop forecasts continue to improve. Still, developed REITs (0.3%) fared better given historically low interest rates and steadily recovering demand, while master limited partnerships (-3.5%) surrendered some of their recent strong gains but are still up 12.2% in 2014. ■

Implied Volatility of Various Markets

March 31, 2009 – July 31, 2014



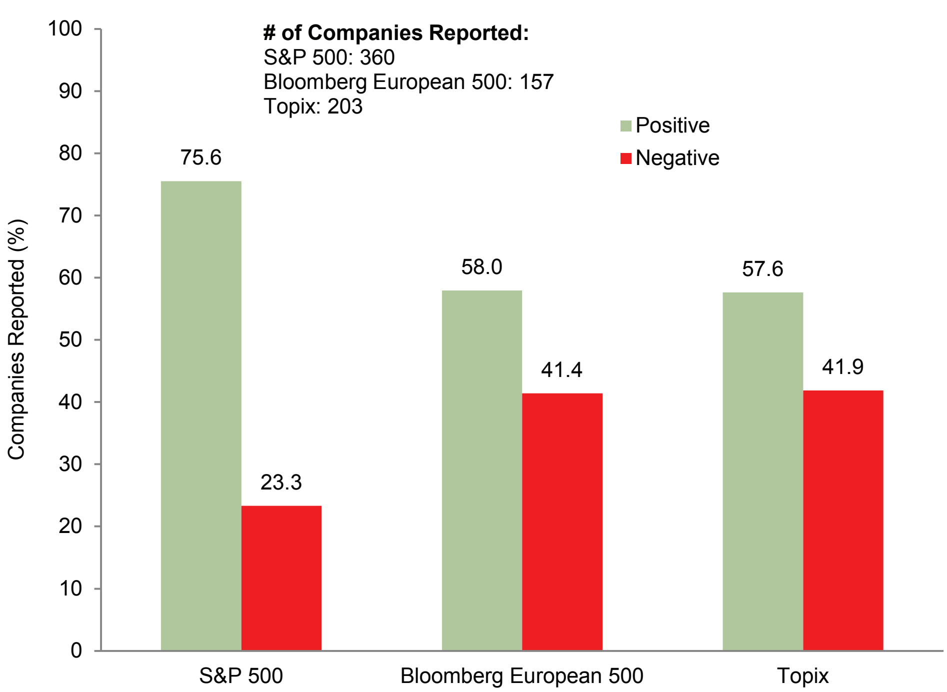
Sources: Bloomberg L.P., BofA Merrill Lynch, Chicago Board of Exchange, J.P. Morgan Securities, Inc., Standard & Poor's, STOXX, and Thomson Reuters Datastream.

See last page for notes.

Volatility sits near recent lows for many assets, suggesting complacency to some and the impact of central bank policy to others. Events during the last week of July show how ephemeral low volatility can be, especially when trading volumes are very thin.

Second Quarter Earnings Surprises: US, Europe, and Japan

Second Quarter 2014

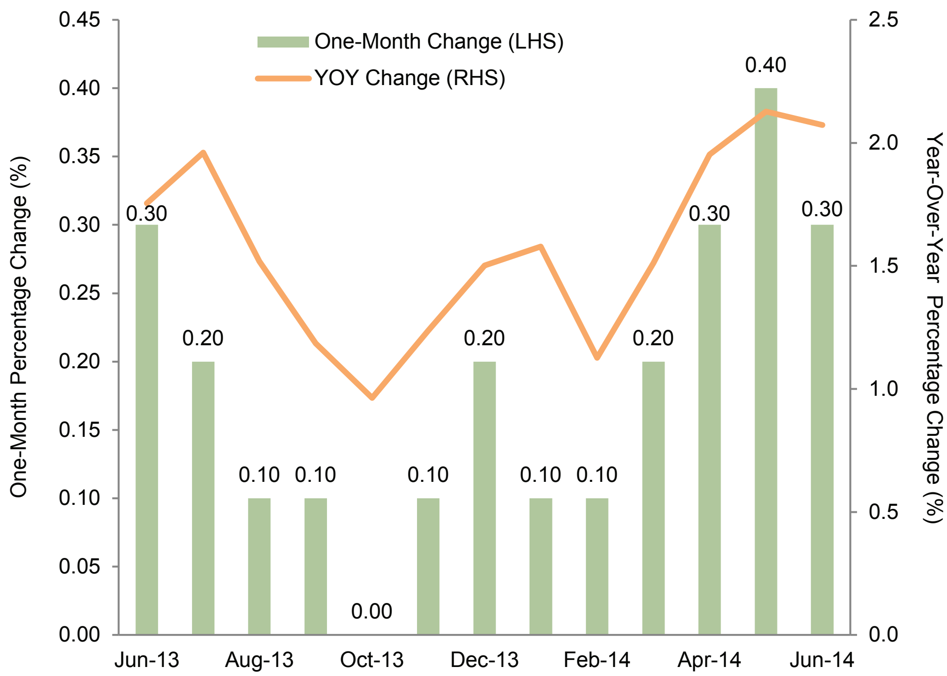


Sources: Bloomberg L.P., Standard & Poor's, Thomson Reuters Datastream, and Tokyo Stock Exchange Group, Inc.

While July was a down month for global equities, earnings results were generally positive, with year-over-year growth of around 10% and 20% for US and European companies, respectively. In contrast, Japanese earnings reports actually showed a 45% decrease, reflecting the benefit to EPS last year of the rapidly depreciating yen.

One-Month and Year-Over-Year Percentage Change in CPI-U

June 2013 – June 2014

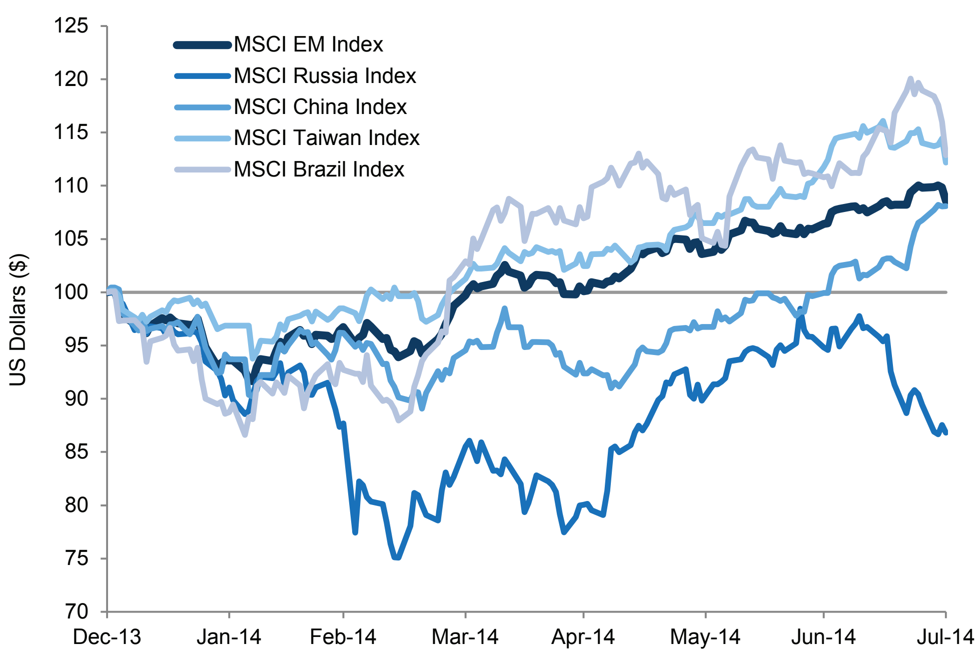


Source: US Department of Labor - Bureau of Labor Statistics.
Note: Data are seasonally adjusted.

Fed Chair Janet Yellen is doing her best to dismiss rising price pressures as "noise" and shift focus from the traditional CPI metric; however, other inflation metrics like the personal consumption expenditure index are also rising and improving growth and job data suggest there may be more to come.

Cumulative Wealth of Emerging Markets Indexes

December 31, 2013 – July 31, 2014 • December 31, 2013 = $100

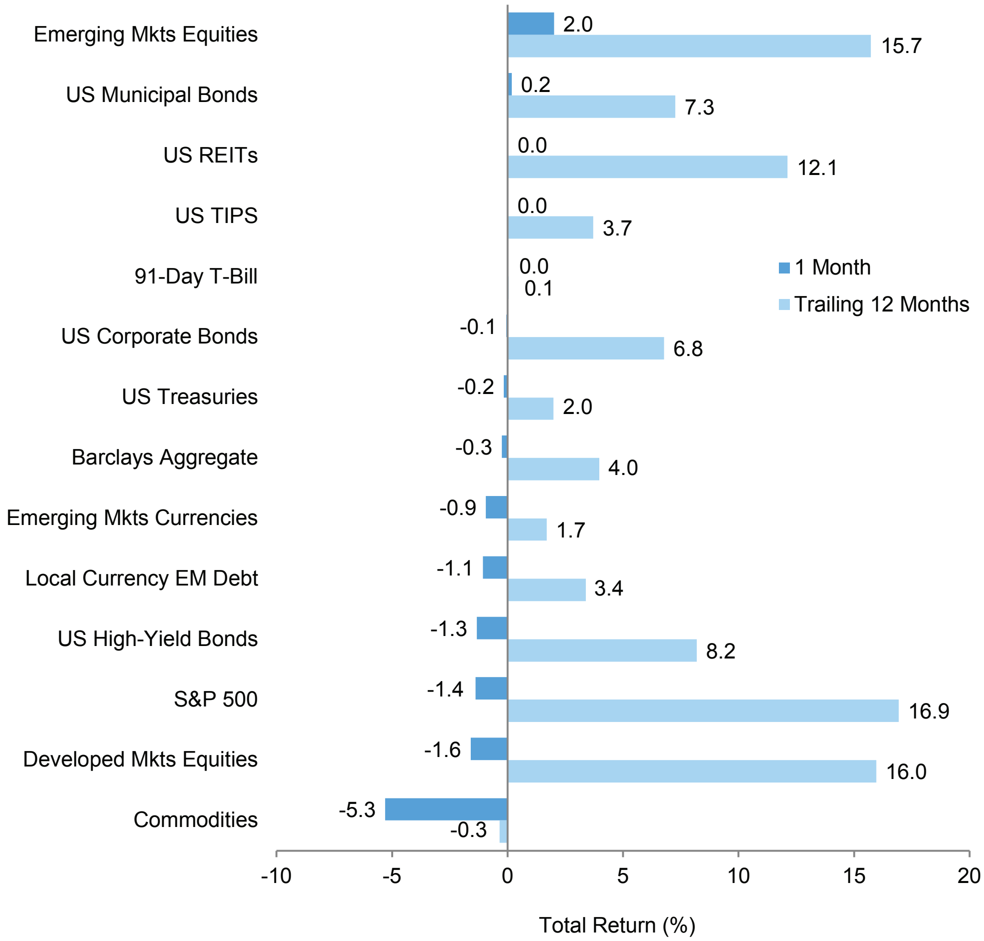


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All data are daily.

Emerging markets significantly outperformed developed markets peers in July: the MSCI EM Index is now beating the MSCI World by 398 bps year-to-date in US$ terms. Asian EM stocks have surged over 10% during the last three months as growth accelerates in China and as optimism grows over the new Indian government.

Index Performance (US$)

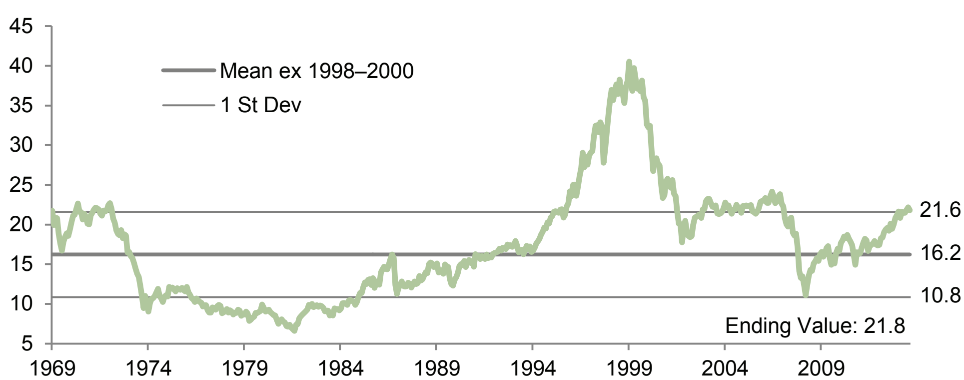
As of July 31, 2014



EM equities were among the best-performing assets in July; the underperformance versus US equities has narrowed over the past year given favorable valuations and rebounding currencies. Commodities were among the worst performers as fears ebb over oil supply and as crop forecasts continue to strengthen.

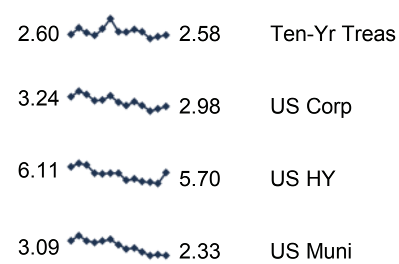
MSCI US Composite Normalized P/E

December 31, 1969 – July 31, 2014



Fixed Income Yields

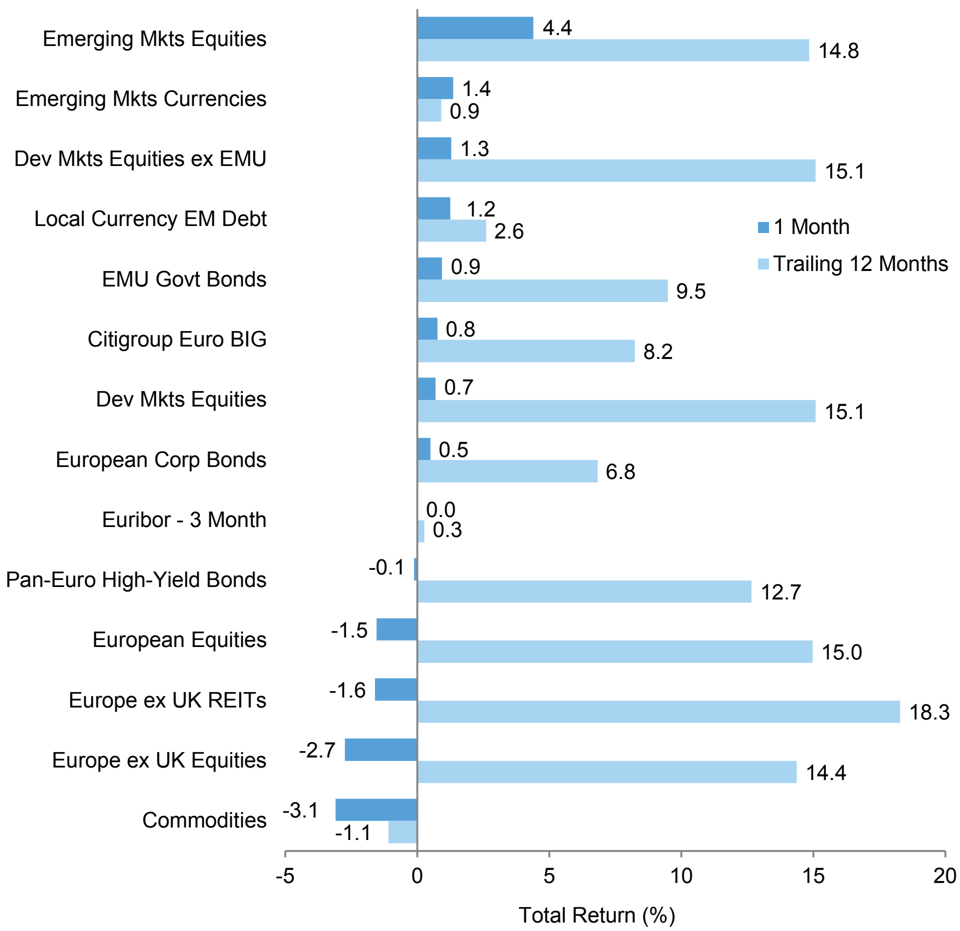
July 2013 – July 2014



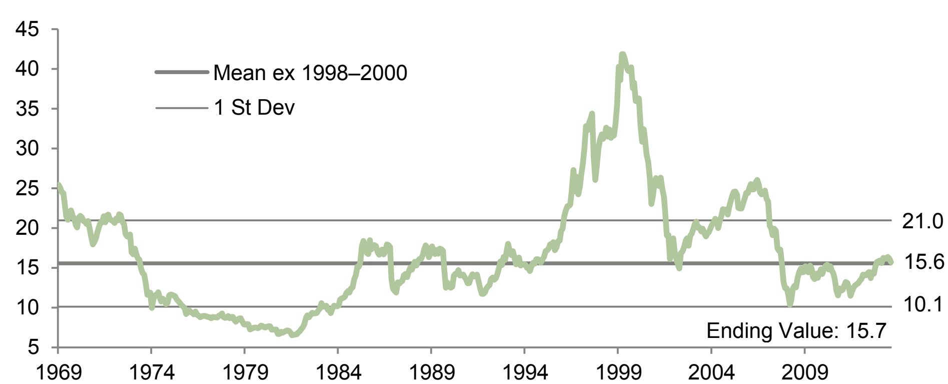
Sources: Barclays, BofA Merrill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

See last page for notes.

Index Performance (€)
As of July 31, 2014



MSCI Europe ex UK Composite Normalized P/E
December 31, 1969 – July 31, 2014



Sources: Barclays, BofA Merrill Lynch, Citigroup Global Markets, EPRA, FTSE International Limited, MSCI Inc., J.P. Morgan Securities, 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.

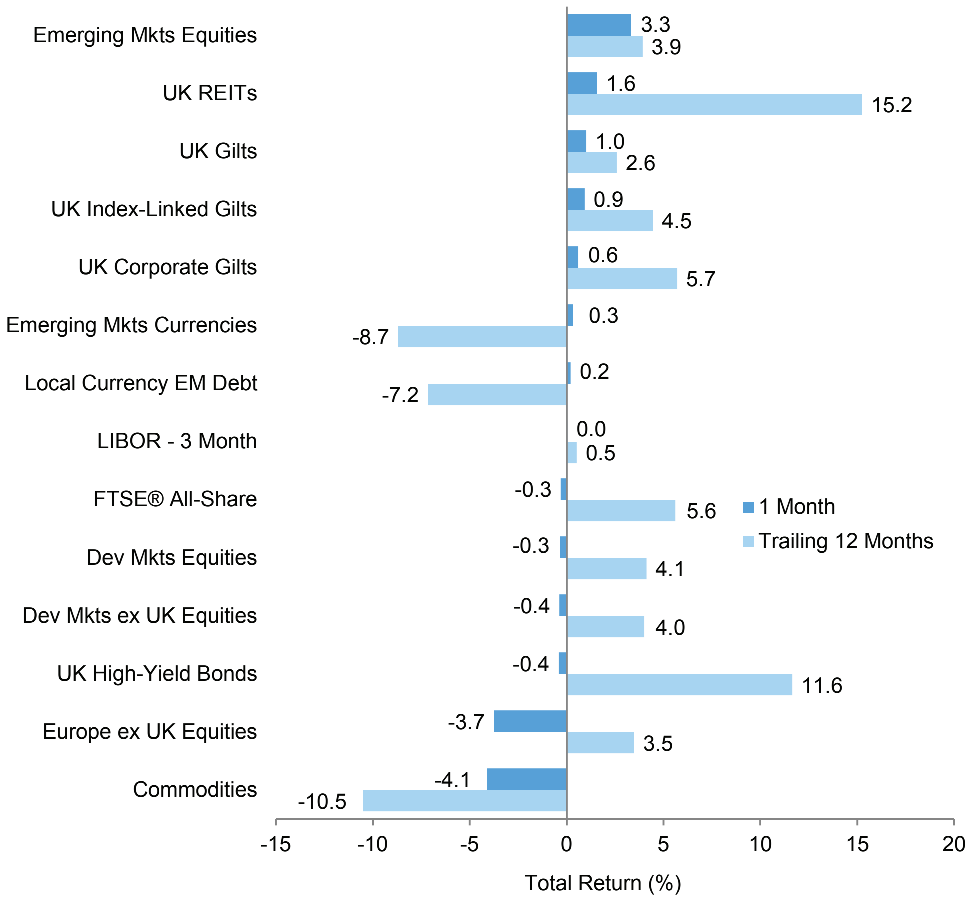
EMU sovereign bonds again generated healthy gains as some yields fell to historical lows; year-to-date, they have outperformed European equities. European stocks suffered despite generally positive earnings data as companies warned about the impact of strong currencies and a slowdown in key export markets.

Fixed Income Yields
July 2013 – July 2014

UK equities fell again in July and have underperformed developed world peers year-to-date; the strong pound has taken its toll on multinationals as is evident by the significant underperformance of EM currencies in GBP terms.

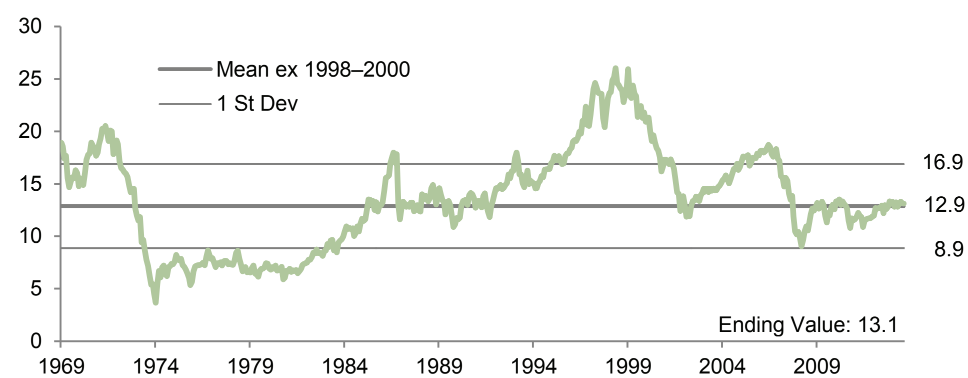
Index Performance (£)

As of July 31, 2014



MSCI UK Composite Normalized P/E

December 31, 1969 – July 31, 2014



Fixed Income Yields

July 2013 – July 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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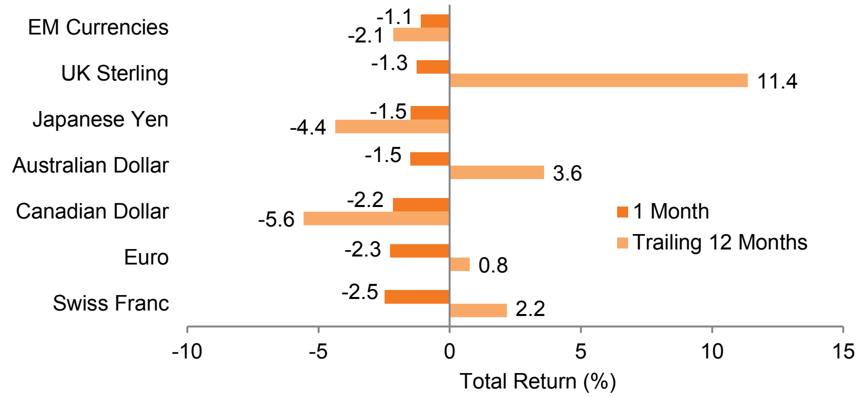
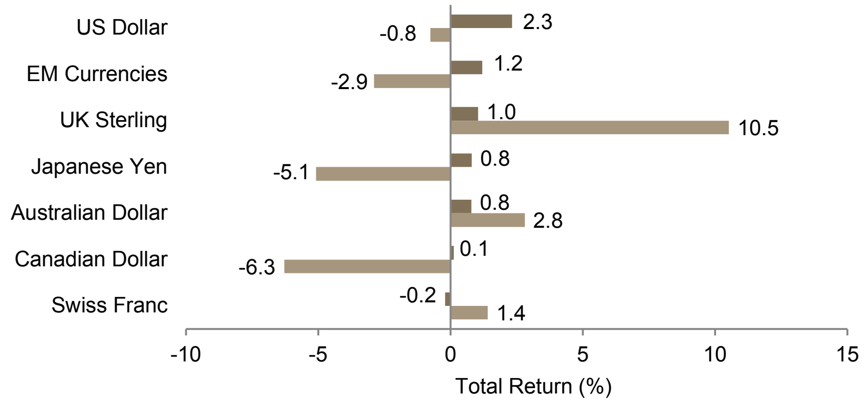
Currency Performance

As of July 31, 2014

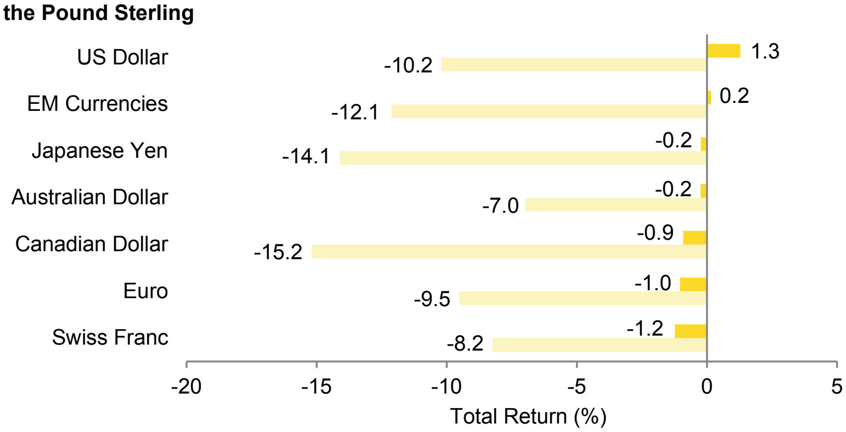
Versus the US Dollar



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.

Stronger growth and rate hike expectations are supporting the US dollar against European currencies like the euro, franc, and pound, and a stronger dollar has also weighed on commodity prices.

The euro fell to an eight-month low against the US dollar but is still up slightly over the past year. To the extent that euro strength has been driven by portfolio flows, this may fade as Eurozone risk assets are underperforming and low yields will limit subsequent bond returns.

Exhibit Notes

Implied Volatility of Various Markets Exhibit
Data are daily. "Currency" is represented by the J.P. Morgan G7 Volatility Index, "EuroStoxx" by the VSTOXX Volatility Index, "Oil" by the CBOE Crude Oil Volatility Index, "S&P 500" by the CBOE SPX Volatility (VIX) Index, and "US Treasuries" by the Merrill Option Volatility Expectations (MOVE) Index.

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

US dollar index performance chart includes performance for the Barclays Corporate Investment Grade, Barclays High Yield Bond, Barclays Municipal Bond, Barclays US TIPS, Barclays US Treasuries, 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, and S&P GSCI™ indexes.

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

UK 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® EPRA/NAREIT UK RE, J.P. Morgan ELMI+, J.P. Morgan GBI-EM Global Diversified, MSCI Emerging Markets, MSCI Europe ex UK, MSCI World, MSCI World ex UK, and S&P GSCI™ indexes.

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.

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