Market Matters

June 30, 2014

Risk assets resumed their ascent during the second quarter as central banks delivered on dovish expectations; investors shrugged off disappointing macro and earnings data and volatility ebbed around historical lows.

Economic and earnings growth disappointed during the second quarter and geopolitical tension escalated in a key oil-producing region, yet risk assets resumed their upward ascent. Reassuringly dovish comments by developed markets central bankers boosted risk appetite, as did a certain indifference to bad news after several years of false starts for a coordinated global economic recovery. Volatility across asset classes (both equity and debt) dropped during the quarter to levels last seen during 2005–06, reflecting a perceived central banker "put," but also highlighting the risks if unexpected developments during the second half of 2014 challenge the complacent consensus.

US equities returned 5.2% for the quarter, slightly outpacing developed markets peers (4.4%). Investors cheered comments from the Federal Reserve that inflation was contained and that asset prices looked in line with historical norms, curiously overlooking May's 2.1% CPI figure (above Fed targets) and a host of metrics that suggest equity valuations are stretched. Of course, June's news that the US economy shrank at an annualized pace of nearly 3% in the first quarter hardly suggests that price pressures are rising; the Fed, the International Monetary Fund, and others have now trimmed GDP growth

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

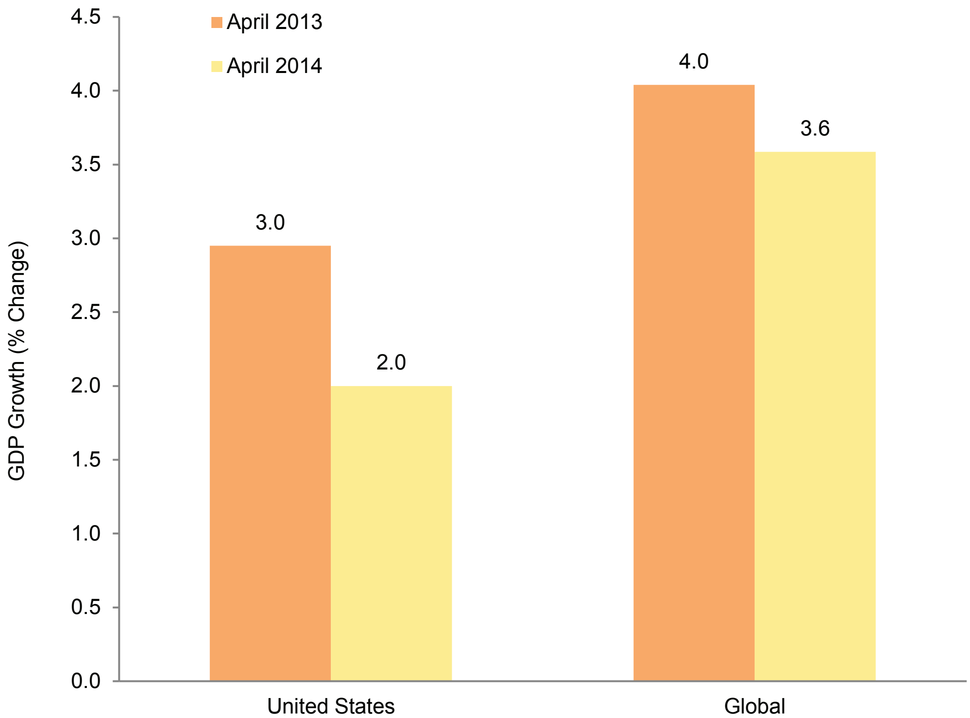
forecasts for 2014. Consensus estimates for S&P 500 earnings growth fell slightly in turn and stand at 7.6%. Given lackluster sales growth, record buyback volumes and margin expansion help explain earnings per share growth. US companies have purchased a record $535 billion of stock over the past 12 months, equivalent to 3.3% of outstanding shares. US fixed income also enjoyed a robust quarter, with the Barclays Aggregate index returning 2.0% (3.9% year-to-date). Technicals in US fixed income markets are very favorable; net supply of US Treasuries is near cyclical lows as the deficit narrows and QE continues, while foreign buying is rising given relative value (yield differentials) and as some countries try to weaken their currencies to restore competitive advantage.

European markets also enjoyed healthy gains, though Eurozone economic data were somewhat downbeat (first quarter GDP growth was barely positive) and disinflation remains a threat (June CPI at just 0.5% was near five-year lows). Last month, the European Central Bank (ECB) delivered on earlier promises to do more to tackle these problems by announcing a package that included rate cuts and funding (LTROs) for banks intended to facilitate SME lending (lending to small and medium enterprises). If credit *demand* rather than supply is the problem, these measures may do little. Eurozone sovereign bonds returned 2.9% as yields fell further, taking their 2014 gain to 6.6%. Returns on European equities (3.0%) trailed world peers during the quarter given growth data and declining earnings forecasts. As was the case in the United States, energy (12.1%) was the best-performing sector as instability in Iraq combined with ongoing OPEC supply problems to push crude oil prices higher and as relative valuations remain favorable. Health care stocks (4.5% in the second quarter; 10.6% year-to-date) have also fared well across regions, in part because the rising level of mergers & acquisitions in the sector (which hit a record $317 billion during the first half of 2014) is lifting target prices.

Emerging markets assets benefited from Fed and ECB guidance, as well as local political and economic developments. EM equities returned 5.2%, outperforming developed peers for the first time since fourth quarter 2012. India (13.5%) was a star performer, as the election of Narendra Modi as prime minister sparked hope that long-awaited corporate reforms would be enacted. In addition, India's currency has stabilized at levels deemed to give a boost to local exporters. Taiwanese stocks (8.2%) also lifted the index as earnings expectations rose for the heavily weighted technology sector. As fears over Fed tapering fade, EM valuations are coming back into focus. The MSCI Emerging Markets Index currently trades at less than 11 times forward earnings, roughly a 30% discount to US equivalents, with normalized valuations suggesting an even larger discount. EM bonds also enjoyed a robust quarter, with US$-denominated sovereigns returning 4.8% and local currency sovereigns up 3.5%. Fragile 5 concerns have not totally disappeared—though rising commodity prices help exporters like Brazil, they have the potential to spark inflation (or increase government deficits if price increases are absorbed) for importers.

Perhaps unsurprisingly, it was a strong quarter for real assets. Leadership rotated as commodities posted flat returns, but property and natural resources securities were up strongly. Within the commodity space, gains on precious metals (3.8%) and energy (4.4%) were offset by plunging agricultural prices (-10.0%) as supply concerns eased. Gold benefited from safe-haven demand given rising tensions in Iraq, while corn and soybeans plunged on news that supplies would be larger than expected. US REITs returned 7.1%, lifting their year-to-date return to 16.2%, while Europe ex UK property securities returned a whopping 11.5%. The dividend yield of 3.52% on US REITs may not appear compelling on an absolute basis, but clearly has appeal relative to ten-year US Treasuries, which yield 2.53%, and US stocks, which yield around 2%. ■

Changing Expectations for 2014 GDP Growth (IMF)

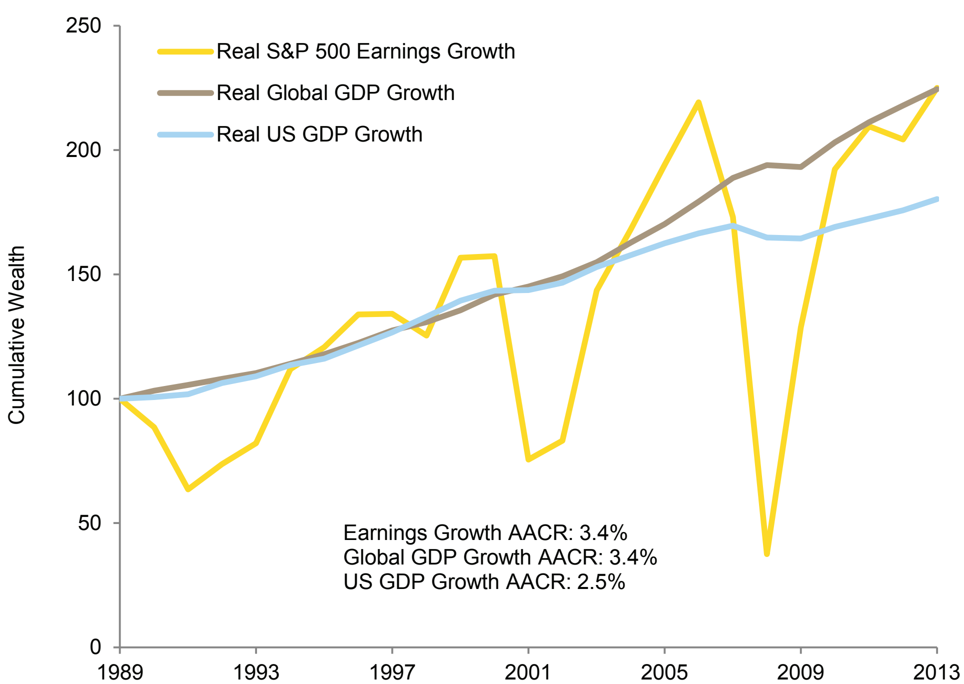


Source: International Monetary Fund.
Note: Global includes 189 countries.

News that the US economy shrank by nearly 3% on an annualized basis in the first quarter has caused growth forecasts to come down; global forecasts are also falling as key emerging economies such as Brazil and Russia continue to disappoint

Real Earnings Growth vs. Real GDP Growth: US and Global

December 31, 1989 – December 31, 2013 • December 31, 1989 = 100

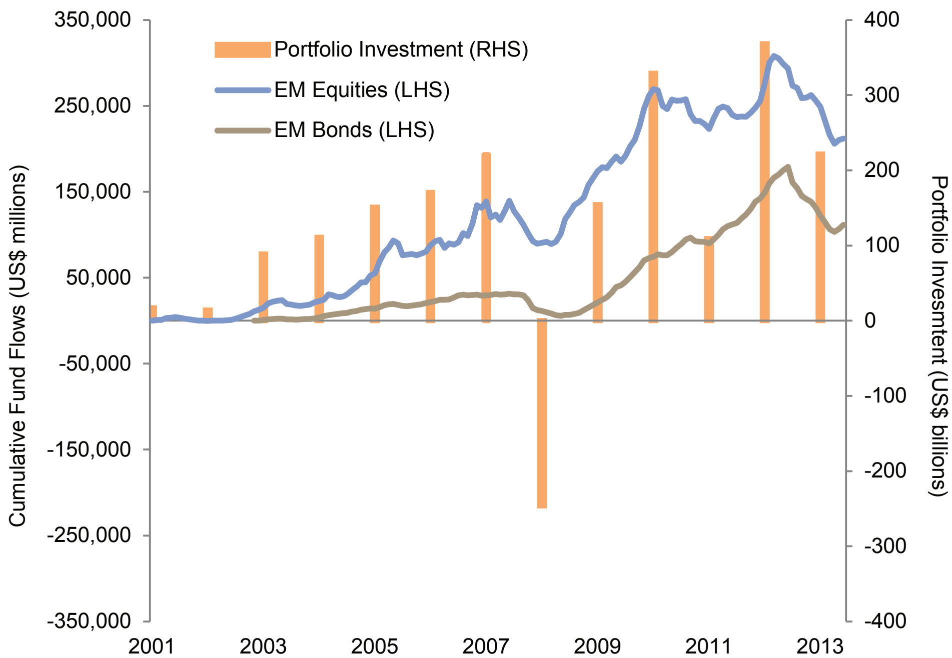


Sources: Global Financial Data, International Monetary Fund, and Thomson Reuters Datastream

Slowing global growth is one reason US (and other) earnings forecasts are coming down

Emerging Markets Fund Flows

2001–14

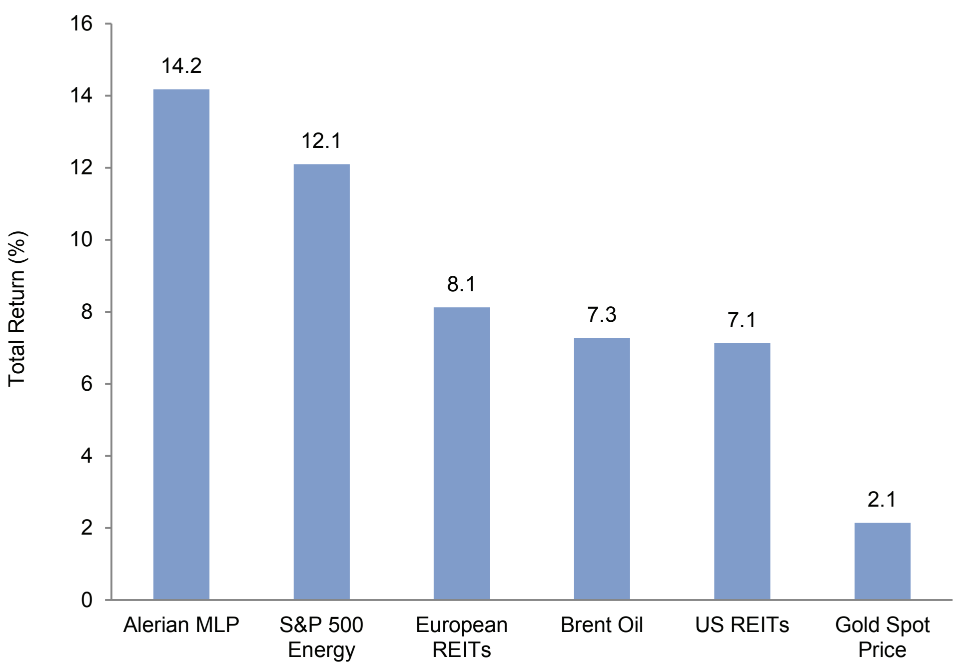


Sources: EPFR Global and International Monetary Fund.
Notes: EPFR data are monthly and IMF data are annual. EPFR data for 2014 are year-to-date through May 31. IMF data only available through 2013. Portfolio investment represents gross capital inflows.

Mutual fund flows have been volatile for EM assets but more comprehensive measures show demand has been more consistent

Real Assets Returns

Second Quarter 2014

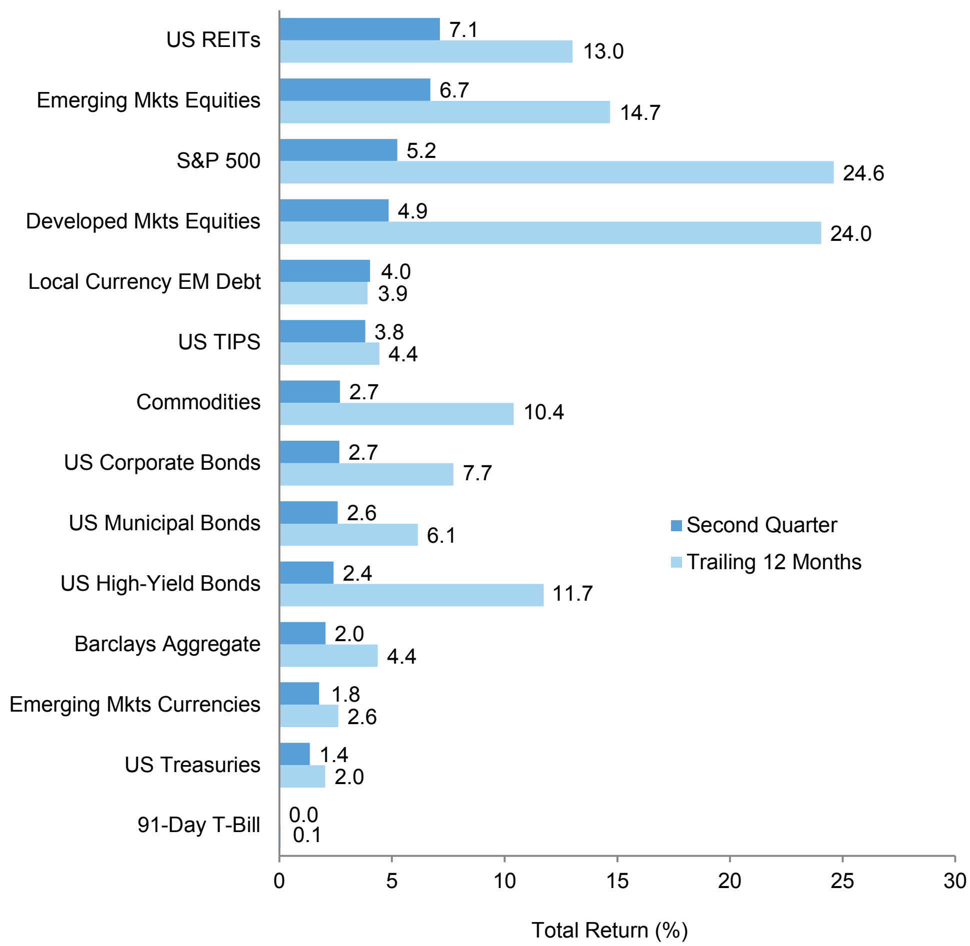


Sources: Alerian, FTSE International Limited, National Association of Real Estate Investment Trusts, and Standard & Poor's.
Notes: US REITs represented by the FTSE® NAREIT All Equity REITs Index. Gold buillion are price levels.

Real assets had a stellar second quarter as interest rates came down and as tension in Iraq contributed to ongoing OPEC supply concerns to push oil higher

Index Performance (US$)

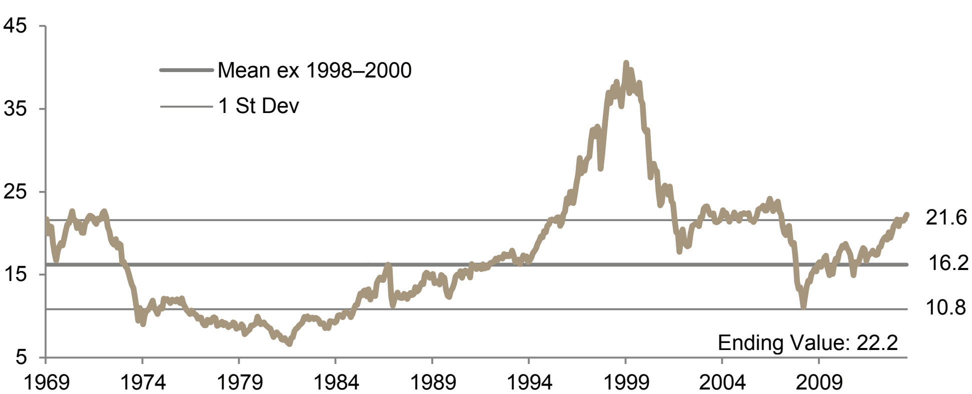
As of June 30, 2014



US REITs had a strong quarter as the 3.5% dividend yield continues to look attractive on a relative basis; EM equities outperformed for the quarter, but still trail US equivalents by nearly 1,000 bps on a trailing one-year basis

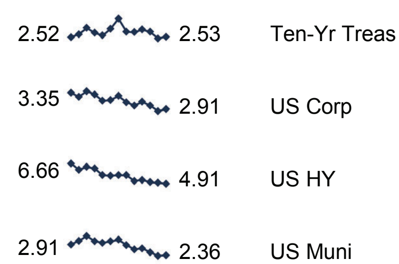
MSCI US Composite Normalized P/E

December 31, 1969 – June 30, 2014



Fixed Income Yields

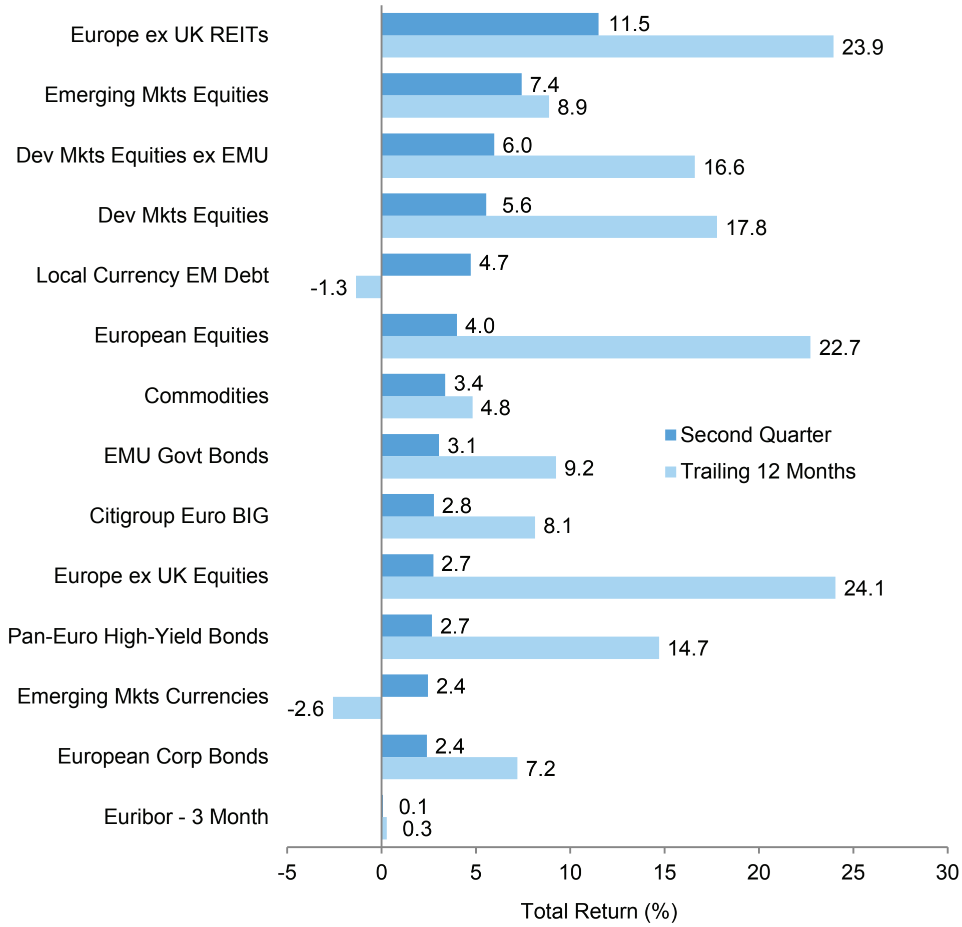
June 2013 – June 2014



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.

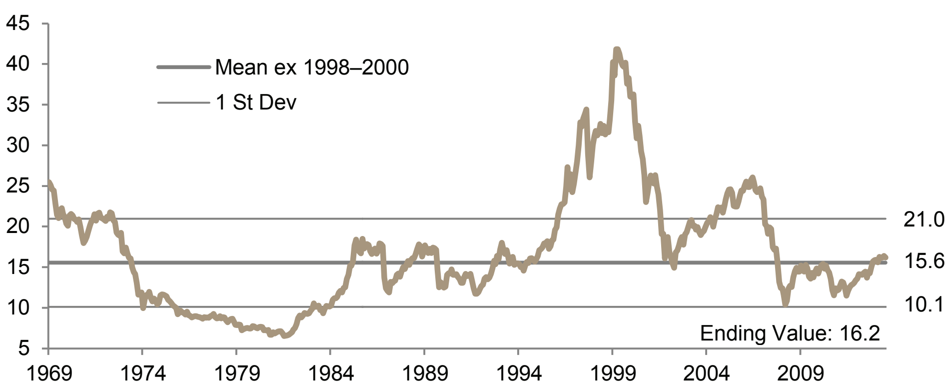
See last page for notes.

Index Performance (€)
As of June 30, 2014



European equities trailed DM and EM equivalents as economic data were weak and earnings expectations were lowered; EMU government bonds posted healthy returns as the ECB eased further and some peripheral yields fell to record lows

MSCI Europe ex UK Composite Normalized P/E
December 31, 1969 – June 30, 2014



Fixed Income Yields
June 2013 – June 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.
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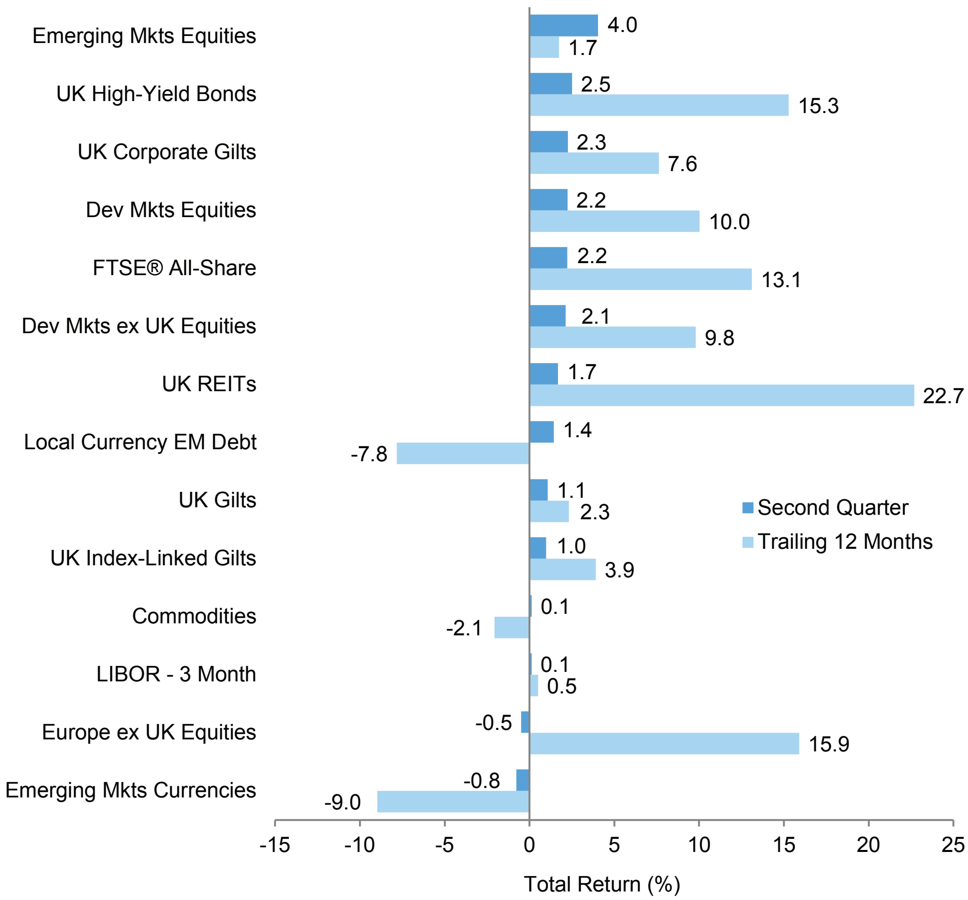
Index Performance (£)

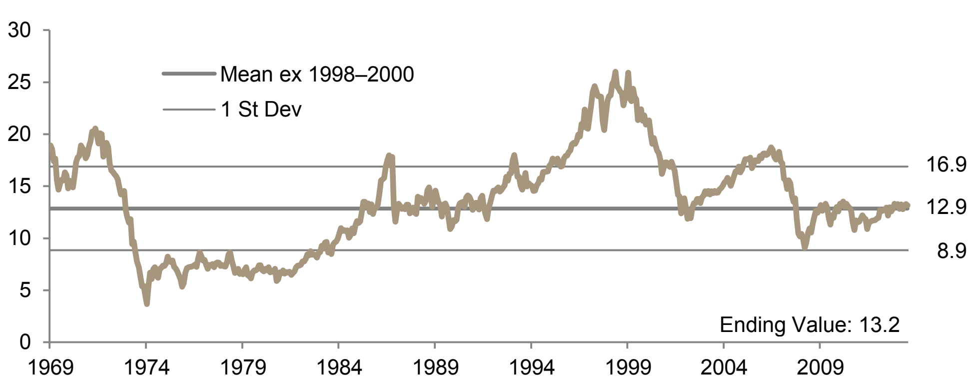
As of June 30, 2014



The UK economy is outperforming but its equity markets are not, in part because of large cyclical exposures to emerging markets and a profitability problem for domestic financials; gilts are underperforming despite weak inflation numbers

MSCI UK Composite Normalized P/E

December 31, 1969 – June 30, 2014



Fixed Income Yields

June 2013 – June 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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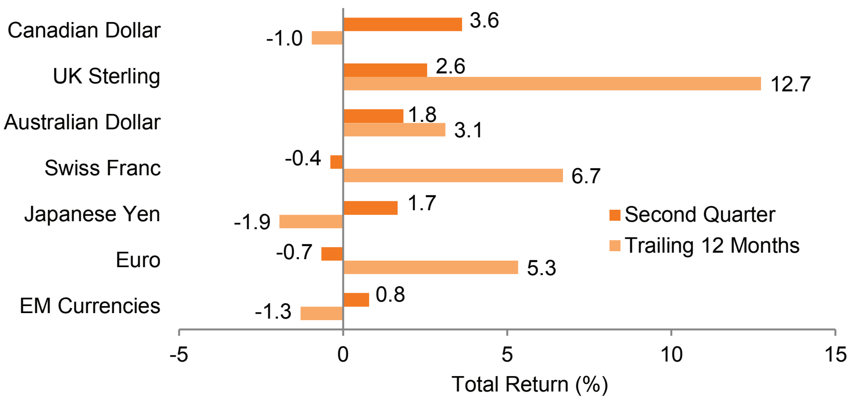
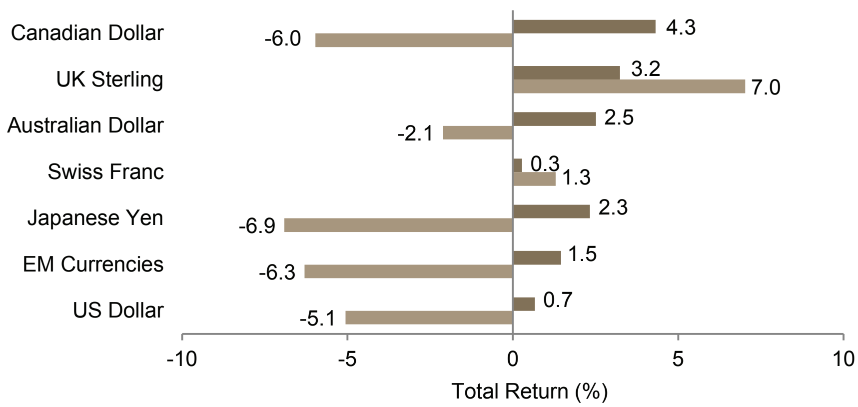
Currency Performance

As of June 30, 2014

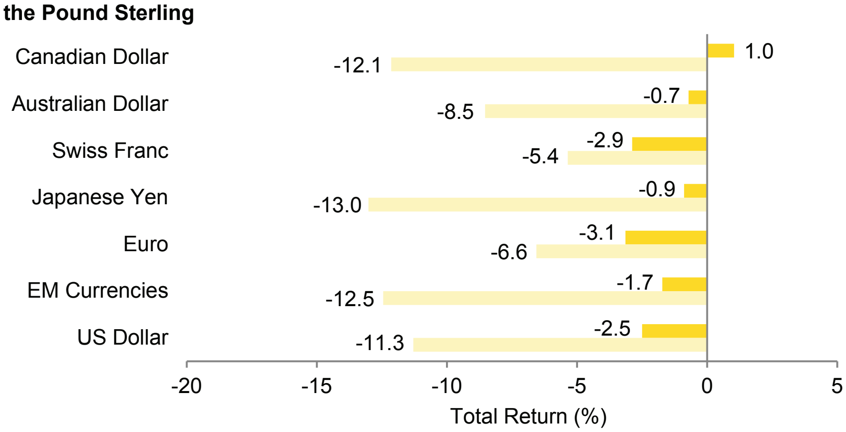
Versus the US Dollar



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.

The Fed and ECB battled during the quarter to talk down their currencies, causing both to weaken against a variety of developed peers

EM currencies posted minor gains against the euro and US dollar (but not the pound); the ruble rebounded as tensions over Ukraine temporarily eased, but some of the so-called Fragile 5 currencies like the rupiah dropped on current account concerns

Exhibit Notes

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.