Market Matters

March 31, 2014

Developed markets equities generated modest returns in the first quarter, taking a breather after a strong 2013. Fixed income markets benefited from softer economic data and dovish signals from developed markets central bankers. Investor outflows and a stable yen weighed on Japanese stocks; emerging markets assets were surprisingly resilient despite ongoing worries about a Chinese slowdown and new flashpoints such as Ukraine.

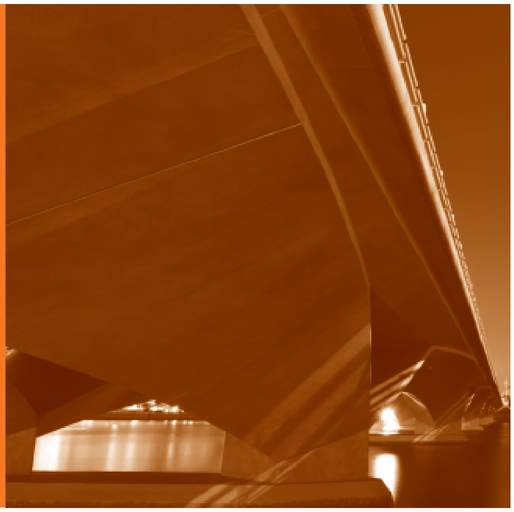
The first quarter came in like a lion and went out like a lamb, with many risk assets recovering from January's rocky start to post modest gains for the period. Global equities (developed and emerging) posted a 1.0% return, their weakest since the Eurozone debt crisis buffeted markets in second quarter 2012. Disappointing growth data, instability in some key emerging markets, and lackluster earnings in many regions helped hold back returns; markets also may simply be taking a breather to digest last year's strong gains and consider what might be next.

US equities returned just 1.8% in first quarter, cooling down after a stellar 2013, as fourth quarter earnings met reduced expectations but sell-side analysts lowered estimates for future growth. Weak housing and employment data earlier in the quarter sparked fears over 2014's growth trajectory, but March brought news that the economy added 175,000 jobs in February, boosting sentiment. GDP grew at a 2.6% annualized pace in fourth quarter,

Access additional exhibits on market performance via the Market Update category on our **Exhibit Finder** application

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

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



below initial estimates but also better than some had feared. Federal Reserve comments moved markets in March, as new Chair Janet Yellen initially suggested that rate hikes could occur as early as the first half of 2015, before later backing away from this claim. Bond markets enjoyed a strong quarter given this mix of dovish guidance and softer data; the Barclays Aggregate Bond Index returned 1.8% (recouping most of 2013's loss) and US high-yield bonds were up 3.0%.

Although they endured a difficult start to 2014, emerging markets equities clawed back most of their earlier losses during the last few days of March and ended the quarter nearly flat (-0.5%). The Chinese government's attempt to rebalance its growth model (in part by allowing the currency to trade within a wider band) has unsettled markets, as has speculation about rising debts across certain sectors. March's announcement of the first Chinese corporate bond default in recent history contrasted with fourth quarter earnings releases from local banks, which continue to be robust. Russia's annexation of the Ukrainian province of Crimea triggered a 9.7% drop for Russian equities (the ruble also fell 6.5% against the US dollar) in first quarter, though losses were trimmed in late March as diplomatic efforts increased to try to contain the crisis. The "Fragile Five" (Brazil, India, Indonesia, South Africa, and Turkey) faded from headlines during the quarter as India and Indonesia shored up their current accounts, though the S&P downgrade of Brazil in March should warn investors not to become complacent. Still, emerging currencies (1.1%) rose during the quarter, and oversold local currency emerging markets sovereign bonds (1.8% in local currency and 1.9% in US$ terms) recouped some of last year's losses.

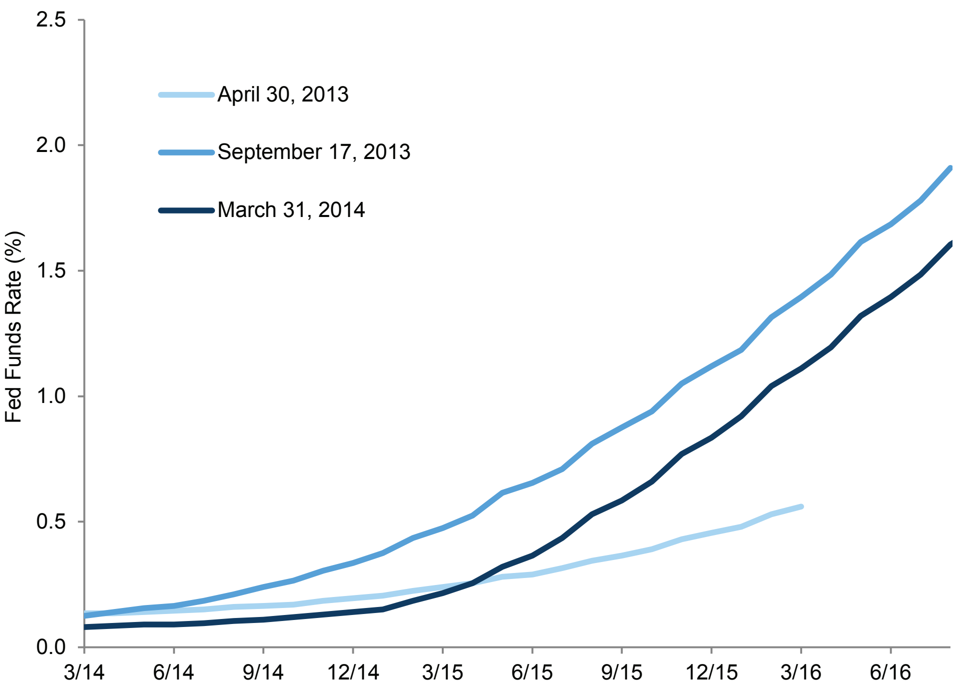
Despite news that earnings contracted another 8% last year, European equities returned 1.8% during the first quarter as investors continued to rotate into this less expensive asset class. Companies are also encouraging sell-side analysts to revise 2014 estimates downward, blaming strong currencies as well as weaker emerging markets demand. Eurozone economic growth may be rebounding slowly, but peripheral imbalances continue to heal and UK data have been much stronger. Of more immediate concern was news that Eurozone inflation fell to just 0.5% in March, the slowest pace since the financial crisis, increasing fears over deflation. The European Central Bank (ECB) has limited ability to cut rates much further, prompting some governing council members in recent weeks to suggest that quantitative easing might be considered. Slow growth and weak inflation combined to generate strong gains for European bond markets; German bunds and UK gilts each returned around 2.5% in first quarter and pan-European high-yield bonds returned 3.3%. Surprisingly, the euro was unchanged against the US dollar, despite ECB President Mario Draghi linking the strong currency to deflation and implying the bank stood ready to intervene.

Japanese stocks (-7.5%) were the worst developed market performer in the first quarter, though this represents only a partial retracement of their whopping 54.6% return in 2013. Concerns over the efficacy of Abenomics are mounting, as Japanese GDP growth disappointed during the second half of 2013 and the yen stabilized against the US dollar. Japanese earnings growth in 2013 was among the world's best, though on an absolute basis (as is the case in Europe) profits are still down roughly 30% from 2007 levels and may no longer be flattered by a declining currency. Investors are also concerned that the upcoming consumption tax hike in April (from 5% to 8%) will impact profits by curbing domestic demand. Foreign investors have pulled around $21 billion from Japanese equities in 2014, reversing some of last year's record $155 billion of inflows.

Commodities (7.0%) were one of the best-performing asset classes in first quarter, rebounding from a disappointing 2013. Precious metals were up 5.4% on the back of dovish central bank guidance and instability in emerging markets, while energy (4.2%) also delivered strong returns on the back of colder weather and supply disruptions. Certain agricultural commodities (16.5%) also delivered large gains given concerns over droughts occurring across some key exporters, but industrial metals (-4.6%) fell given worries about lower Chinese demand. Finally, US REITs (8.5%) and Europe ex UK property securities (5.0%) generated strong returns as yields declined, bouncing back from a disappointing 2013. ■

Expected Path for US Fed Funds Rate

March 31, 2014 – August 31, 2016

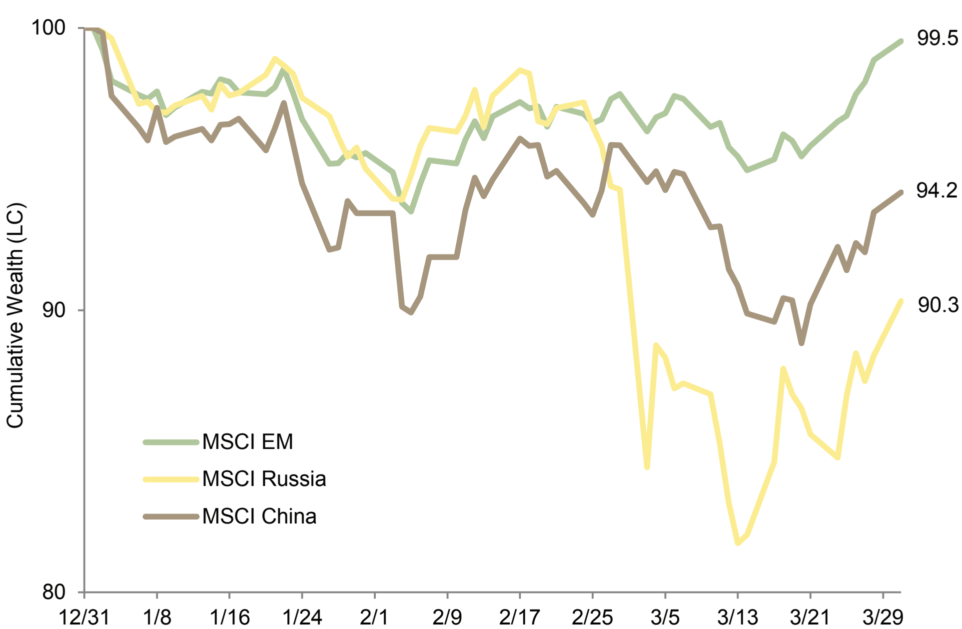


Source: Bloomberg L.P.

Markets wobbled in March when FOMC Chair Janet Yellen suggested rate cuts might occur as soon as the first half of 2015—but tightening fears have ebbed since September

First Quarter 2014 Emerging Markets Performance

Local Currency · December 31, 2013 = 100



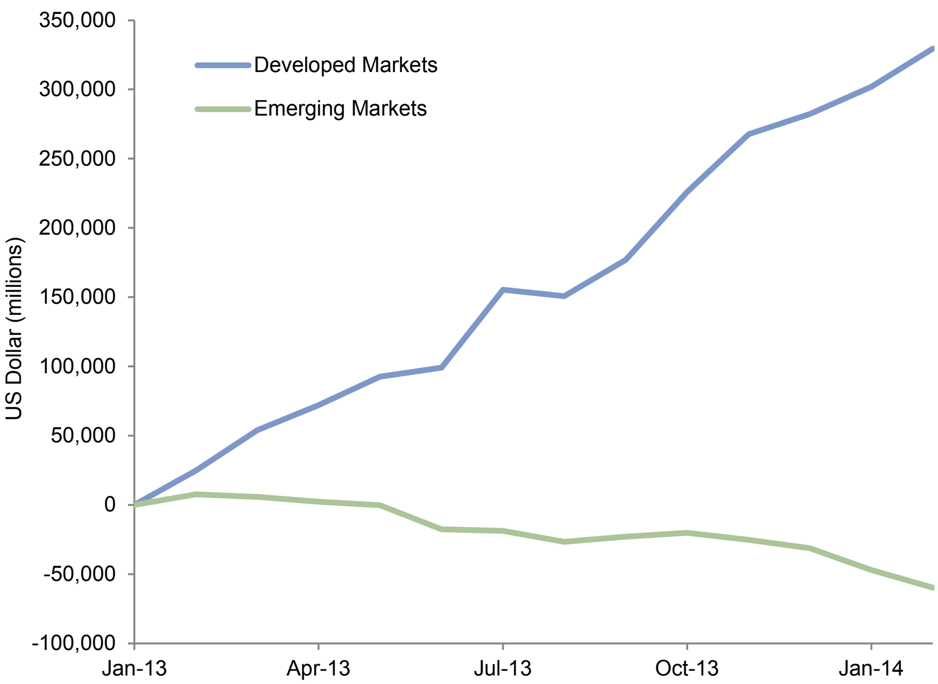
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: All data are daily.

EM equities were surprisingly resilient during the first quarter despite concerns over slowing Chinese growth and Russia's intervention in Crimea

Cumulative Fund Flows

January 31, 2013 – February 28, 2014

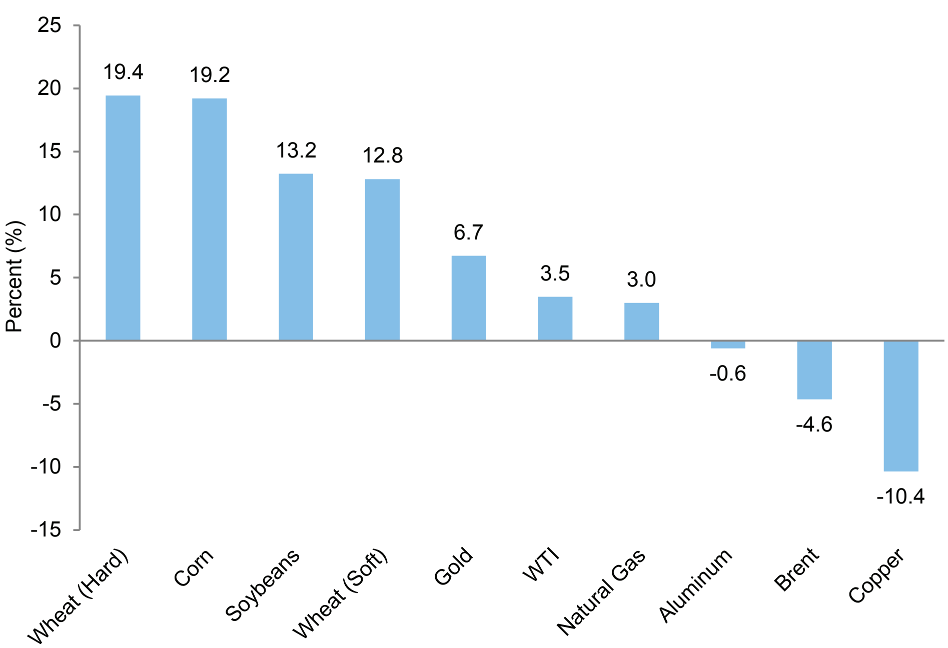


Source: EPFR Global.

Notes: Fund flows data are as of April 1. Data are monthly and may revise.

Equity investors continue to pour money into developed markets, though composition is changing as Japan falls out of favor

First Quarter 2014 Performance of Commodities

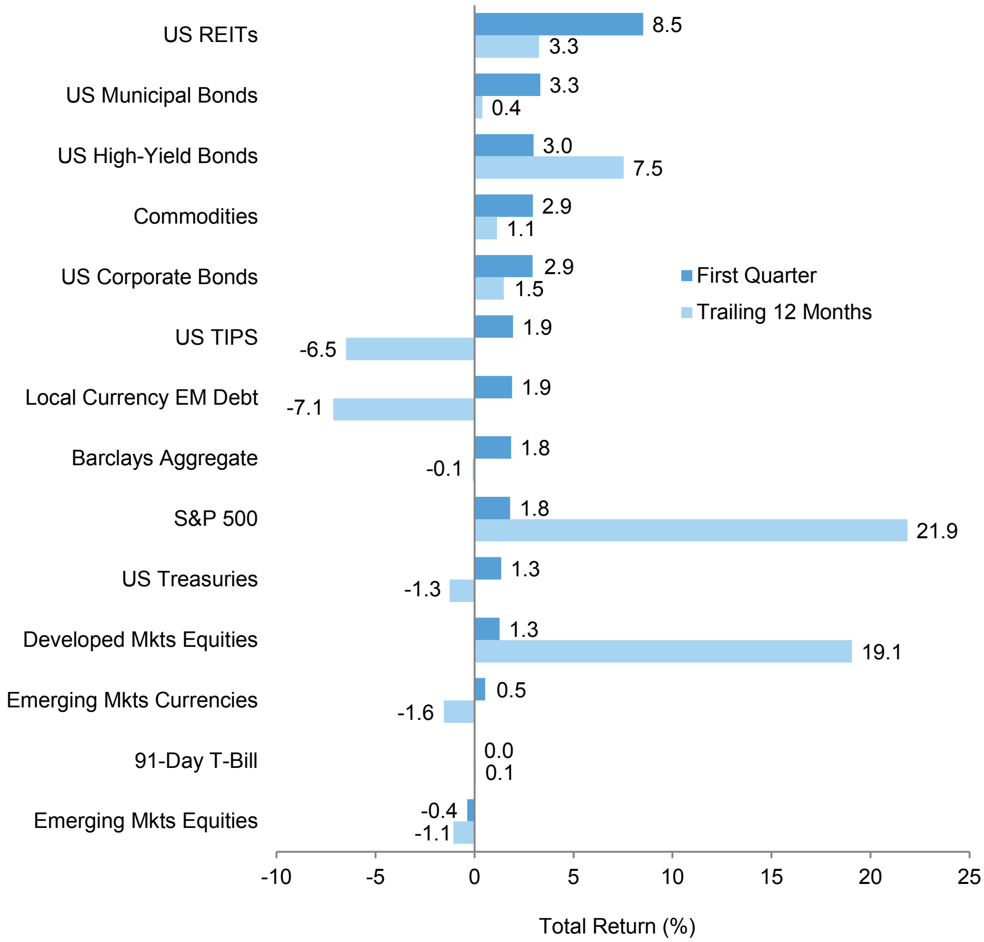


Source: Thomson Reuters Datastream.

Agriculture generated strong returns given drought in Brazil; industrial metals are suffering given concerns over reduced Chinese demand; US cold weather boosted energy demand

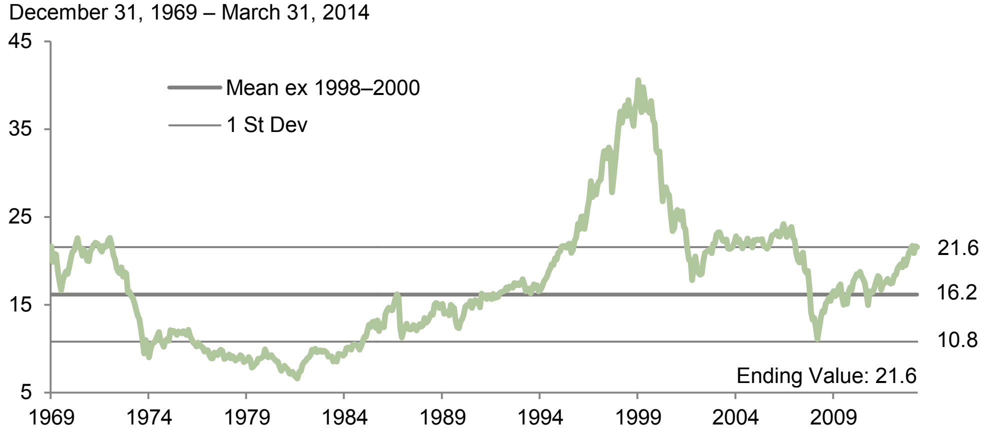
Index Performance (US$)

As of March 31, 2014



MSCI US Composite Normalized P/E

December 31, 1969 – March 31, 2014

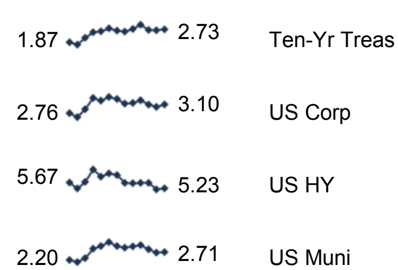


Sources: Barclays, BofA Merill Lynch, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
See last page for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

Real estate and fixed income recovered from a disappointing 2013 as yields declined; US equities slightly outperformed global peers in the first quarter despite high valuations and slowing earnings growth

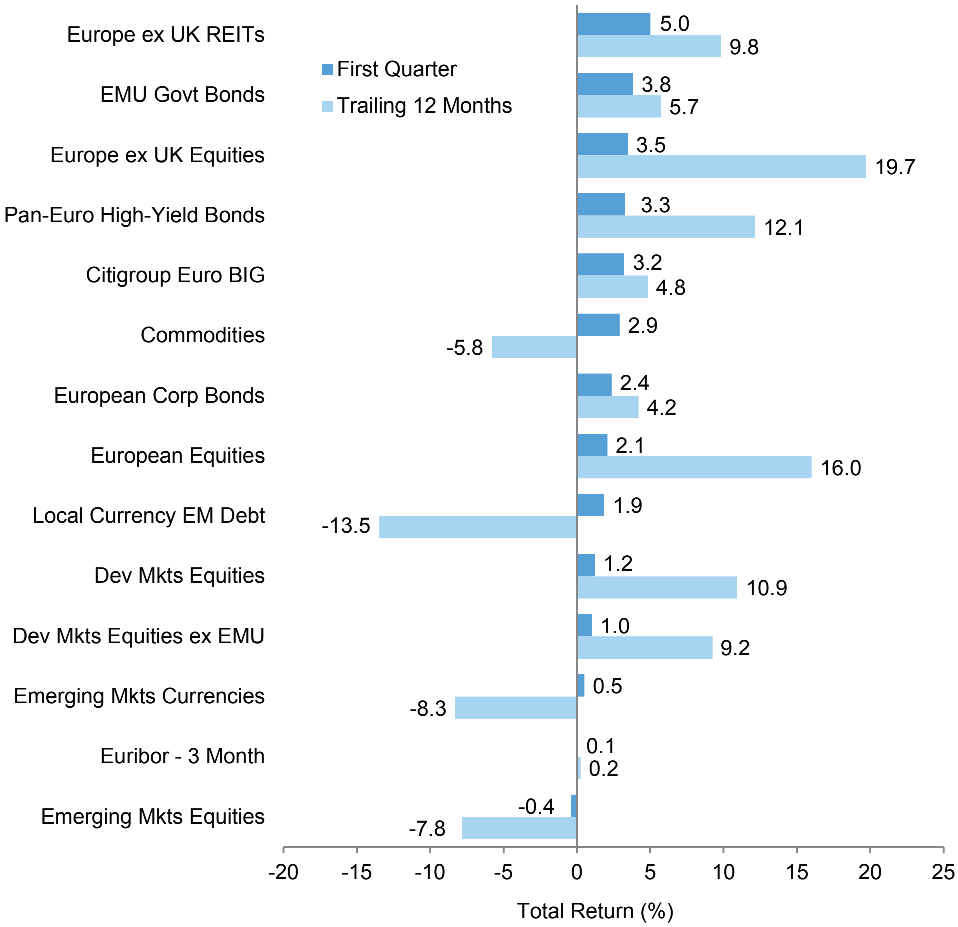
Fixed Income Yields

Mar 2013 – Mar 2014



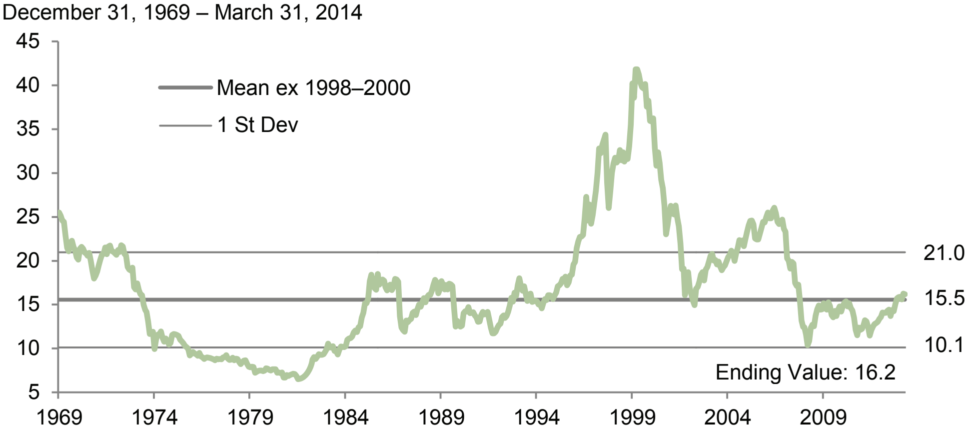
Index Performance (€)

As of March 31, 2014



MSCI Europe ex UK Composite Normalized P/E

December 31, 1969 – March 31, 2014



Sources: Barclays, BofA Merill 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.

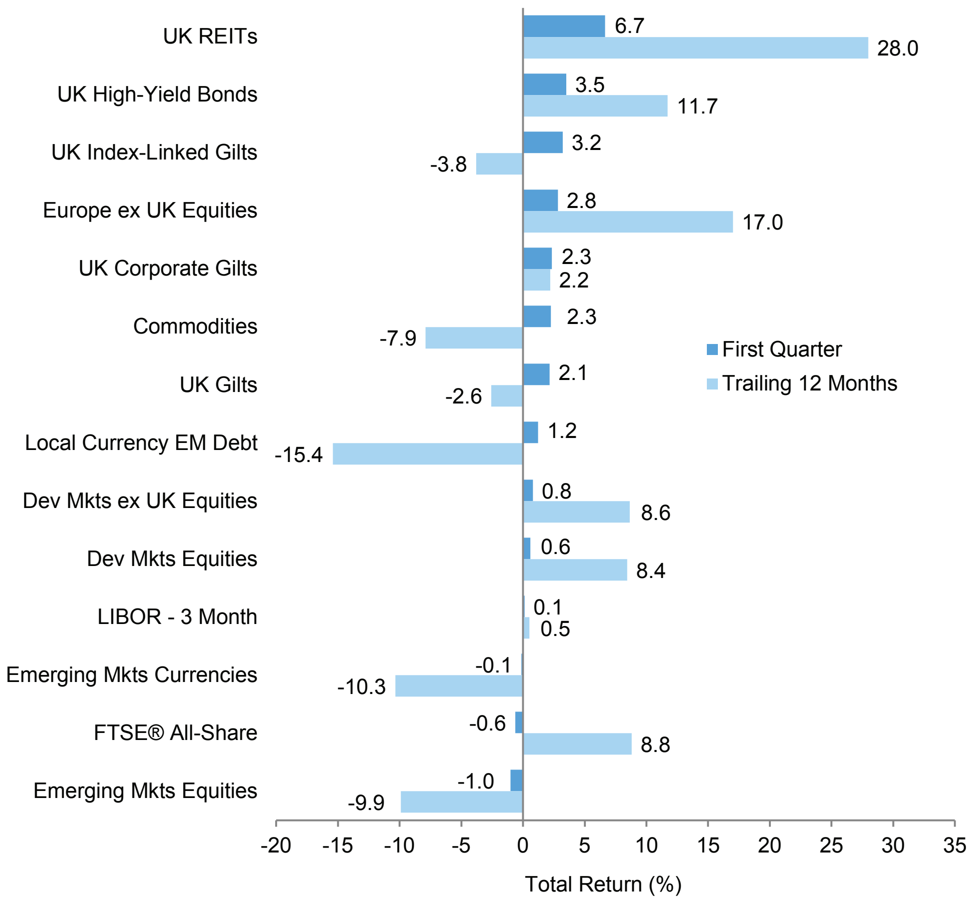
EMU sovereign bonds generated robust returns as some yields fell to historical lows; European equities outperformed given attractive valuations and investor inflows, ignoring disappointing earnings

Fixed Income Yields

Mar 2013 – Mar 2014

Index Performance (£)

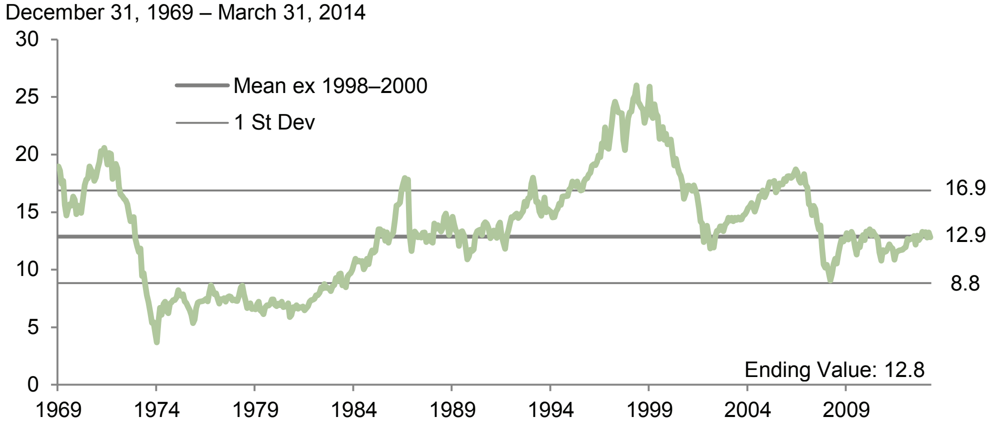
As of March 31, 2014



Stronger UK growth yet falling inflation has contributed to strong gains for property and fixed income; UK equities have trailed given high exposure to out-of-favor emerging markets

MSCI UK Composite Normalized P/E

December 31, 1969 – March 31, 2014



Fixed Income Yields

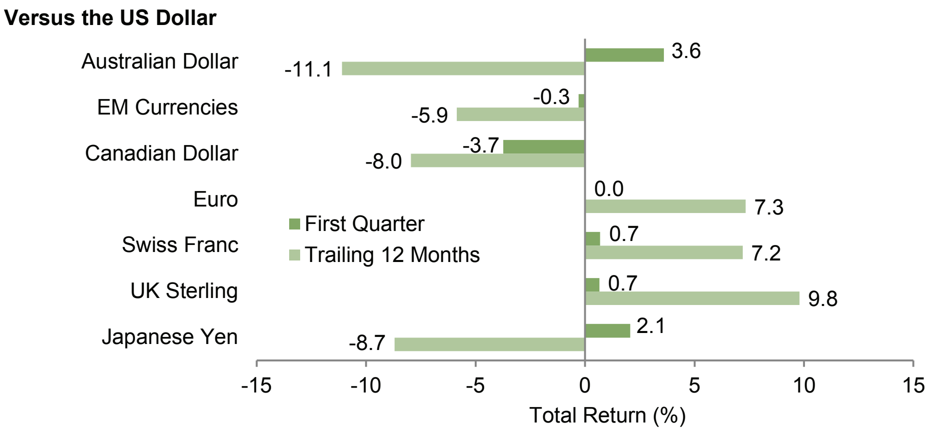
Mar 2013 – Mar 2014

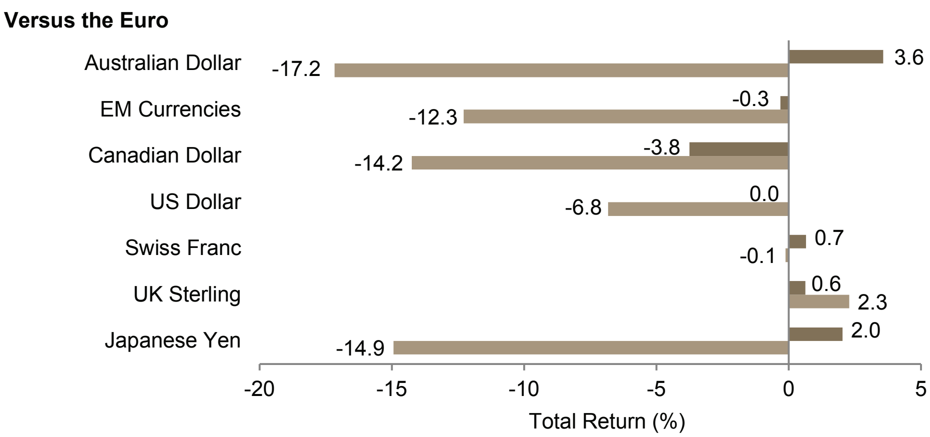
Sources: Barclays, BofA Merrill Lynch, EPRA, FTSE International Limited, J.P. Morgan Securities, Inc., MSCI Inc., National Association of Real Estate Investment Trusts, Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

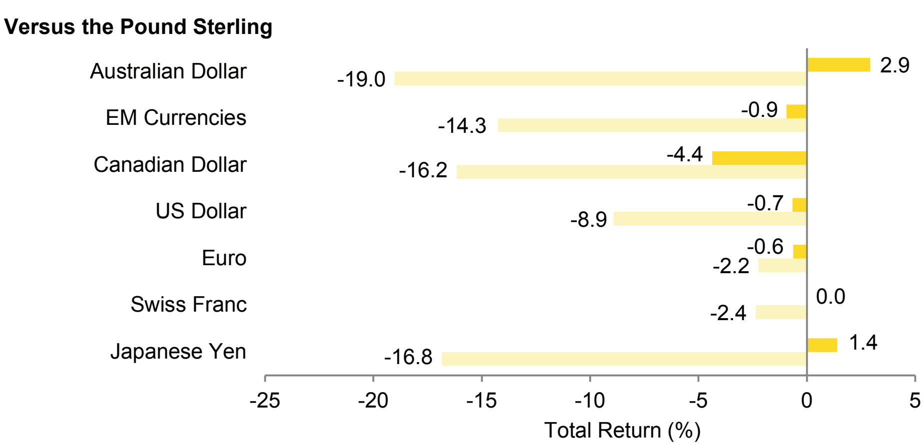
See last page for notes.

Currency Performance

As of March 31, 2014







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 has appreciated against the US dollar year-to-date and confounded speculators; the euro has held its ground despite falling yields given a current account surplus

EM currencies slowed their recent slide given rate hikes and easing balance of payments pressures; the Australian dollar recovered some ground but remains heavily out of favor given China exposure

Exhibit Notes

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.

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.